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REAUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION, 1988–90

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO AUTHORIZE APPROPRIATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION FOR FISCAL YEARS 1988-90

MAY 13, 1987

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REAUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION, 1988-90

WEDNESDAY, MAY 13, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 9:35 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Sasser, Sanford, Wirth, Garn, Armstrong, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. The committee will come to order.

We begin these hearings this morning at a time of great transition and challenge within the SEC and today we want to review carefully where we are now and where we are going.

We are very pleased to have Chairman Shad with us.

We very much appreciate the willingness of Chairman Shad to appear before this subcommittee this morning and I understand, Mr. Chairman, that you are in the midst of preparing for your confirmation hearing to become the U.S. Ambassador to the Netherlands and on behalf of myself and the subcommittee and the full committee, we want to wish you every success in that endeavor.

You have been the longest serving Chairman in the history of the Securities and Exchange Commission and during your term much has been accomplished. I would hope that the administration would not delay much longer in appointing an outstandingly qualified individual with a strong reputation in enforcement and securities law to be your successor.

Since this is in all likelihood your last appearance before the Securities Subcommittee, I want to take a minute to review some of the many changes that have taken place during your distinguished tenure.

These include the 1982 Integration of Corporations Registration and Reporting Requirement and the Shelf Registration Rule; the simplification of proxy statements and prospectuses; the initiation of the electronic disclosure system known as EDGAR; supervision over a record number of insider trading cases and impressive enforcement actions involving the worst series of securities law violations that have come to light since the creation of the Commission; the 1982 Swiss Accord and subsequent cooperation agreements on

enforcement matters with Japanese, Canadian and U.K. authorities, the 1984 resolution of the turf battle between the SEC and the Commodities Futures Trading Commission; and continued attention to the growing internationalization of the securities market which is a concern to all of us.

These are only a few of the many issues in which you have played a major and a leadership role and I want to thank you for what you have done. You clearly have earned a justified position in the history of the Commission and we are appreciative of that.

I also want to note at this point your extreme generosity to higher education. There are at least 3 of the members of this committee that attended the Harvard Business School, myself among them, and we want to express our appreciation as well—and I believe that of everyone else who has had any association with that institution—for your pledge to fund the bulk of a new $30 million business leadership and ethics program at the business school. I think that's a very major development and one also that deserves acknowledgment.

Now this morning, in terms of reviewing where we are and where we are going, we will be considering the Securities and Exchange Commission's request for a 3-year budget authorization for 1988 through 1990. The SEC has requested an overall budget increase for 1988 of about 30 percent from its 1987 level. The request will result in a less than 10 percent increase in authorized staff positions for the Commission. The additional staff will be allocated primarily to the Enforcement Program and the Full Disclosure Program. Very small increases or no increase at all are planned for the staffs of the market regulation, investment management, legal services, and other important programs.

The balance of the requested increase is planned for nonpersonnel costs, largely for funding the EDGAR project to automate the disclosure/filing operation.

This request comes at a time of staggering growth in both the volume and complexity of the securities markets. Virtually every measure of activity in the industry has reached record-breaking levels in the past several years. Just since 1982, the number of shares traded on the New York Stock Exchange rose over 150 percent, the number of registered broker-dealers increased almost 90 percent, registered investment advisers multiplied by 180 percent and now control about $1.5 trillion in assets representing some 15 percent of all financial assets owned by Americans.

Complaints received by the National Association of Security Dealers have jumped about 120 percent.

Moreover, the sweeping growth of activity has been accompanied by a host of new regulatory demands. The introduction of new securities products has spawned program trading and the expiration Friday phenomenon with its associated very volatile market swings.

Dangerous abuses of the Government securities market led to new legislation last year granting the SEC regulatory authority over Government security dealers.

Complex new regulatory issues are unfolding as a result of the rapid trend toward internationalizing the securities markets, wherein the need to keep our markets competitive must be bal-

anced with the need to continue to adequately safeguard the interests of American investors and the integrity of U.S. securities markets.

Finally, an unprecedented wave of corporate takeover activity has resulted in questionable tactics by a host of market participants.

There seems to be widespread agreement that the SEC has performed as well as might be expected in this turbulent environment considering the resource limitations which the agency has been operating under for the last several years. Yet at hearings in February before this subcommittee in this room, a number of witnesses from the securities industry urgently supported increases of up to 100 percent in the SEC's resources.

The executive officer of a major securities firm described some of the current problems in the markets as beyond the ability of the industry alone to resolve and called for further regulatory assistance.

However, based on some of the testimony presented at that hearing and reiterated by GAO findings, the increases requested by the SEC for 1988 might be characterized as more of a restaffing of the agency rather than a real increase.

During this time of unparalleled growth and change in the securities market, the SEC has basically failed to increase its staff since 1980 and has held its overall budget growth at a level which must call into question its ability to regulate markets which have changed dramatically since 1980.

While the increase requested for 1988 appears warranted under the regulatory circumstances, it is difficult to comprehend why the increase has been so long in coming and, given the determined posture of the Commission to resist growth for the past several years, whether that budget increase will be sufficient to allow the agency to keep pace with the industry that it regulates.

Now the SEC's restraints on growth are even more curious in view of the fact that the agency is in effect self-funding through fee assessment to its users. Recently, the SEC has been generating revenues which exceed its budget by 100 percent.

The results of this budgetary restraint were noted at 2 recent hearings. Last month, U.S. Attorney Rudolph Giuliani testified before the full Banking Committee that the single most important action that could be taken to stem illegal trading activities would be to bolster the resources of the SEC.

Separately, at hearings before the Securities Subcommittee, in February, a former SEC general counsel noted that the Commission's review of annual reports and annual proxies, 2 documents frequently relied on by individual investors, has declined from 100 percent review to less than 20 percent of those being filed being subjected to regulatory oversight.

He also noted that only about 5 percent of the registered broker-dealers will be examined by the SEC in 1988 and he described this as "decidedly inadequate."

Several other witnesses questioned the ability of the industry's self-regulatory organizations to effectively assume the increased regulatory burdens which the agency has been deferring to them as

a method of avoiding the resource requirements of direct SEC oversight.

And finally, the need for more action by the Commission to develop and implement automated market surveillance systems has also been emphasized to us by various witnesses.

Now in addition, the Commission itself indicates in its budget submission that the growth in investment companies and investment advisers has far outstripped the agency's resources to maintain appropriate oversight in this area.

As a result, the SEC is trying to persuade State regulators and the industry itself to take up the slack while the agency plans for only a minimal rise in its own staff for this program in 1988.

So while the SEC may well be performing appropriately considering the resource limitations that have been adopted, all of these factors indicate the need I think, for a serious inquiry as to whether the agency has kept up with the growth in the industry and whether the 1988 authorization request adequately provides for the regulatory demands of today's security markets.

I would say one other thing and then indicate who else will be testifying and call on my colleagues. We are clearly in a period of extraordinary change in the securities markets. In my discussions with the heads of major investment houses and others, they are frank to say to me that even they are having difficulty keeping track of the explosion of new instruments and the changes that are going on in the worldwide securities markets—24-hour trading, program trading, portfolio insurance, and on and on.

It seems to me that it's very important that we not fall behind the curve in terms of having the SEC be able to stay certainly abreast of and hopefully even ahead of an understanding of what these changes are and to be able to deal with them in a way that really maintains the integrity of the markets and shareholder confidence.

So I think we are at a point where we have to not only look back and look where we are at the moment, but try to foresee what's out in front of us. There's really no one better equipped, Chairman Shad, to try to give that assessment than yourself because you've lived through this period, you've been in charge through a number of very significant gains that the SEC has made that I cited earlier, and so your reflections on where we are and where we're going I think are particularly important to the country at this time. I don't think there's anybody else that's really equipped to give us that sense perhaps as fully as you are. So your testimony today I think is very, very important.

After you have spoken, we will hear from the Assistant Comptroller for the General Accounting Office and then finally from Ed O'Brien who serves as the president of the Securities Industry Association.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

As the chairman noted in his opening remarks, today's hearings on authorization for the SEC probably marks the last opportunity

for Chairman Shad to appear before us. With that prospect in mind, I would like to thank and commend Chairman Shad, a fellow Utahn, for his distinguished leadership and service at the Commission.

Chairman Shad has served since 1981, longer than any other Chairman of the SEC. It's difficult for me to believe that that many years have passed. It doesn't seem too long ago that we sat across this podium at your confirmation hearings. My hair is a lot thinner and you're a lot thinner than you were during that period of time.

Let me just divert for a moment and tell a story publicly that some of my colleagues know. Not too long after John became Chairman of the SEC, we were talking about flying—obviously one of my favorite subjects. The Chairman asked me if I had ever jumped out of an airplane before and I said, "No, but I've always wanted to. I've flown them all of these years but I've never jumped out of one of them."

So he arranged for us to go to Maryland. We took my two older sons with us and the four of us went through 4 or 5 hours of training, jumping off a tower. I had done this in the Navy many years before, all except for jumping out of an airplane. As we went through training, the old 82nd Airborne sergeant who was giving us our training suggested that he had a very special chute for Chairman Shad. So I got him aside—and I don't know whether the Chairman has ever heard this or not—but I said, "What is this business? Why does the Chairman of the SEC get a special parachute and I don't?" And he said, "Well, it really isn't special. It's just 6 feet bigger in diameter for his weight." [Laughter.]

So that was when he was heavier. But we did jump that day, my two sons and Chairman Shad and I. It was a great experience that I will never forget. There was some reference to it in one of the newspapers and Barry Goldwater came up to me and said, "Jake, I understand you jumped out of an airplane." I said, "Yes, Barry, I did." He said, "Why would you do that? Was it on fire?" I said, "No, Barry, it was just for fun." And he said, "Well, I'll never understand why you would want to jump out of a perfectly good airplane."

But anyway, aside from our responsibilities here, that was a great experience, one that my two sons will also not forget. None of us has jumped since, though. We've stayed inside our perfectly good airplanes.

Senator RIEGLE. Jake, I wonder if the Chairman has ever had the thought in mind of asking some of the rest of us to take a flying jump?

Mr. SHAD. Could I interject that I invited Congressman Dingell to join us and offered to pack his chute. [Laughter.]

Senator GARN. Well, maybe we can continue that invitation in Holland. [Laughter.]

Anyway, during your tenure as Chairman, you have overseen a period of unparalleled growth in the Commission's role as a regulator.

For example, from 1982 to 1986, the number of registered broker-dealers increased by almost 90 percent. The number of shares traded on the New York Stock Exchange has risen by over 150 per-

cent, bringing total assets under SEC management to about $1.5 trillion.

During this period of very explosive growth in all aspects of the securities markets, the SEC under Chairman Shad's direction has increased investor protections, reduced corporate financing and paperwork costs, and brought record numbers of enforcement actions. This has all been accomplished with minimal staff and expenditure increases and I, for one, greatly appreciate your efforts, Chairman Shad, to not only improve efficiency but to control costs.

In addition to the enlightened management abilities that Chairman Shad brought to his post, perhaps most importantly he's been a champion and example of the belief that—and I quote—"ethics pays." John Shad truly lives and practices what he preaches. As the chairman mentioned, he recently donated most of a $30 million gift to support a Harvard Business School program on ethics; as we are constantly reminded, Mr. Chairman, actions always speak louder than words.

Personally, it has been a great pleasure to associate with you over the last 6 years while you were Chairman of the SEC and when I was chairman of this committee. It has been a great privilege to work with you and I thank you for the great service you have provided this country.

[The complete prepared statement of Senator Garn follows:]

Statement of Senator Jake Garn
Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities
May 13, 1987

TODAY'S HEARING ON AUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION MARKS PERHAPS THE LAST OPPORTUNITY TO RECEIVE TESTIMONY FROM JOHN SHAD AS CHAIRMAN OF THE SEC. WITH THAT PROSPECT IN MIND, I WOULD LIKE TO THANK AND COMMEND CHAIRMAN SHAD, A FELLOW UTAHN, FOR HIS DISTINGUISHED LEADERSHIP AND SERVICE AT THE COMMISSION.

CHAIRMAN SHAD HAS SERVED SINCE 1981, LONGER THAN ANY OTHER SEC CHAIRMAN. DURING HIS TENURE CHAIRMAN SHAD HAS OVERSEEN A PERIOD OF UNPARALLELED GROWTH IN THE COMMISSION'S ROLE AS REGULATOR. FOR EXAMPLE FROM 1982 THROUGH 1986 THE NUMBER OF REGISTERED BROKER-DEALERS INCREASED ALMOST 90%, AND THE NUMBER OF SHARES TRADED ON THE NEW YORK STOCK EXCHANGE ROSE OVER 150% BRINGING TOTAL ASSETS UNDER SEC MANAGEMENT TO ABOUT $1.5 TRILLION. DURING THIS PERIOD OF EXPLOSIVE GROWTH IN ALL ASPECTS OF THE SECURITIES MARKETS, THE SEC UNDER CHAIRMAN SHAD'S DIRECTION HAS INCREASED INVESTOR PROTECTIONS, REDUCED CORPORATE FINANCING AND PAPERWORK COSTS, AND BROUGHT RECORD NUMBERS OF ENFORCEMENT ACTIONS. THIS HAS ALL BEEN ACCOMPLISHED WITH MINIMAL STAFF AND EXPENDITURE INCREASES AND I FOR ONE GREATLY APPRECIATE CHAIRMAN SHAD'S EFFORTS TO NOT ONLY IMPROVE EFFICIENCY BUT ALSO TO CONTROL COSTS.

IN ADDITION TO THE ENLIGHTENED MANAGEMENT ABILITIES THAT CHAIRMAN SHAD BROUGHT TO HIS POST PERHAPS MOST IMPORTANTLY HE HAS BEEN A CHAMPION AND EXAMPLE OF HIS BELIEF THAT, AND I QUOTE, "ETHICS PAYS". JOHN SHAD TRULY LIVES AND PRACTICES WHAT HE PREACHES. RECENTLY CHAIRMAN SHAD DONATED MOST OF A $30 MILLION GIFT THAT WILL SUPPORT A HARVARD BUSINESS SCHOOL PROGRAM ON ETHICS AND AS WE ARE CONSTANTLY REMINDED ACTIONS ALWAYS SPEAK LOUDER THAN WORDS.

Senator RIEGLE. Senator Sanford.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you very much, Mr. Chairman.

I thank Mr. Shad for being here and for his diligent efforts in managing the Commission in what certainly has become a dynamic securities industry. Indeed, the securities industry is growing and changing so rapidly that new regulatory issues are raised every day. We are faced with an explosion in the merger and acquisition area and a related dramatic increase in insider trading cases, we are also adjusting to a growth of program trading, the internationalization of our capital markets, the boom in new and creative ways to finance corporate takeovers, and so it is a time of many, many changes, and I know, increasing demands.

I have been concerned about the trends in corporate takeovers, the increasing amount of debt being carried by our corporations as a result of this takeover mania, and the constantly unfolding scandals that are related to it.

Right now, the largest corporation in North Carolina, Burlington Industries, is being swept up by this takeover mania and many of my concerns are manifest in the Burlington takeover case, concerns that I've had for several years.

That takeover was conceived by a partnership of Canada's largest textile firm, Dominion Textiles, and the widely renowned takeover artist, Mr. Edelman. The takeover was allegedly originally formulated using insider information provided by a former high level Burlington employee to the investment banking firm which initially created the deal. This takeover, like the vast majority of takeovers of late, is being financed largely by debt raised through the pledging of the assets or proposed pledging of assets of Burlington.

If the takeover is successful, I fear that yet another major U.S. manufacturing firm will be left broken apart, saddled with debt, with little to show for it other than the payout of large fees to Mr. Edelman and the profits to the investment bankers.

The Burlington takeover is a case in point of the problems with the takeover disease plaguing our country. I can assure you that the competition from imports has made our textile industry lean and mean and a report recently released by the Office of Technology Assessment would attest to that fact. Thus, there is no reason to believe that Burlington will emerge from this takeover in a leaner, meaner, more competitive position.

There is, however, reason to believe—indeed, Mr. Edelman has stated—that the true goal of his hostile bid is to generate short-term profit gains on the transaction and to sell off assets to service the bridge loans, bank loans, and other debt incurred in the purchase.

And who benefits from such sales? Not the 20,000 Burlington employees located in North Carolina or the some 18,000 located in many other States, some of which are represented by colleagues on this committee, including hundreds or even thousands of workers in Tennessee, Pennsylvania, Alabama, and New York, among others. Nor do the communities in which the plants and corporate headquarters are located benefit. The Winston-Salem-Greensboro

area of North Carolina has recently suffered more than its fair share of losses as a result of mergers and corporate moves. Nor even do our capital markets benefit; they are losing more of the public trust with every deal, based on insider information that appears on the front pages of our newspapers.

I am concerned that as we begin to look at what must be done to better police our securities markets and to improve the regulation of corporate takeovers that we keep in mind the entire constituency of our corporations—management, shareholders, employees, customers, the community that the corporation serves, and the very industrial underpinning and might of America.

I appreciate the excellent work, Chairman Shad, that you have done to address many of these concerns, I look forward to your testimony which touches on these fundamental takeover problems that have recently come home so vividly to North Carolina.

Thank you.

Senator RIEGLE. Thank you, Senator Sanford.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I'm going to ask that my statement be read in the record as if given in its entirety.

Senator RIEGLE. Without objection.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, John Shad is a close personal friend and a constituent and a gentleman who has given true meaning to the word public service.

By coming to the Government John Shad had to make a tremendous financial sacrifice in the divestiture of many of the securities that he owned so that there would be no question with respect to his stewardship at the SEC. His decision to liquidate his securities cost him personally and his family millions and millions of dollars, not to mention the economic sacrifice in terms of what his earnings were prior to that.

He came during a rather stormy, turbulent time. I might say that the media was not generous. They were carping. They were looking to embarrass. There was a tremendous controversy surrounding his nomination which was fueled by some fellow commissioners and some staffers, who were not willing to give this gentleman the benefit of the doubt, who were ready to just take him apart as soon as he arrived.

I must say, John, I hope that you are filled with a feeling of pride because you have, I believe, converted the doubters. You have made believers of some of your harshest critics. Your integrity, your stamina, your tenacity during these turbulent times has been a great credit to you, your family, to your beliefs, and of course all of those who count you among their friends.

I am privileged to have had the opportunity to work with you, to undertake some very significant legislation, whether it be in the Government securities area or in the area of insider trading. In terms of recognizing the importance and the role of the SEC, you have been a magnificent Chairman and I want you to know that this Senator appreciates greatly the tenacity and the strength of

character that you demonstrated during both the tough times and triumphant times.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

MAY 13, 1987

I WOULD LIKE TO NOTE FOR THE MEMBERS OF THE SUBCOMMITTEE, MANY OF WHOM ARE NEW, THAT THIS MIGHT BE JOHN SHAD'S LAST APPEARANCE BEFORE US. JOHN SHAD WILL SOON DEPART FOR THE NETHERLANDS. IT HAS BEEN A TRUE PRIVILEGE TO WORK WITH HIM DURING THE LAST 6 YEARS.

I DO NOT MAKE THIS STATEMENT BECAUSE JOHN SHAD IS A FRIEND AND, MORE IMPORTANTLY, A CONSTITUENT. I COMMEND JOHN SHAD FOR A SOLID RECORD OF ACHIEVEMENT AS CHAIRMAN OF THE SEC.

AT A TIME WHEN THE INTEGRITY OF PUBLIC OFFICIALS IS UNDER STRICT SCRUTINY, I AM GLAD TO HAVE JOHN SHAD, A TRULY DEDICATED PUBLIC SERVANT, BEFORE US TODAY. UNLIKE MANY OF HIS COLLEAGUES FROM WALL STREET, JOHN SHAD HAS NOT ONLY SURVIVED THE RIGORS OF WASHINGTON SINCE HIS APPOINTMENT TO THE SEC IN 1981, HE HAS HAD THE LONGEST TENURE OF ANY SEC CHAIRMAN IN THE COMMISSION'S HISTORY.

JOHN SHAD HAS BEEN AS SUCCESSFUL IN WASHINGTON AS HE HAD BEEN IN NEW YORK BECAUSE HE LEADS BY EXAMPLE. RATHER THAN MERELY PONTIFICATE ABOUT THE APPARENT ABSENCE OF ETHICS ON WALL STREET, JOHN SHAD IS CONTRIBUTING BOTH TIME AND MONEY TO FIGHT THIS PROBLEM. HOPING TO FORGE A WEAPON TO CURB THE ABUSES ON WALL STREET, JOHN IS DONATING MOST OF A $30 MILLION GIFT TO SUPPORT A HARVARD BUSINESS SCHOOL PROGRAM ON ETHICS.

HIS TENURE HAS OCCURRED AT A TIME WHEN THE SECURITIES MARKETS HAVE EXPANDED GEOMETRICALLY. RATHER THAN RECITE A LITANY OF THE SEC ACCOMPLISHMENTS DURING HIS TENURE, I WOULD LIKE TO THANK HIM FOR HIS AND THE COMMISSION'S ASSISTANCE IN THE SUCCESSFUL ENACTMENT OF THE INSIDER TRADING SANCTIONS ACT, THE SECONDARY MORTGAGE MARKET ACT AND THE GOVERNMENT SECURITIES ACT. I ALSO COMMEND HIS EFFORTS TO INCREASE OVERSIGHT OF THE

INTERNATIONAL SECURITIES MARKETS WITH INTERNATIONAL ACCORDS WITH THE SWISS AND HIS EFFORTS TO BRING THE COMMISSION INTO THE COMPUTER AGE THROUGH THE DEPLOYMENT OF THE EDGAR SYSTEM.

WHILE CHAIRMAN SHAD AND I HAVE BEEN IN AGREEMENT MOST OF THE TIME, WE HAVE HAD OUR, SHALL I SAY, MINOR DIFFERENCES. FOR EXAMPLE, I HAVE OFTEN URGED HIM TO REQUEST MORE FUNDS FOR THE SEC. WHILE HE HAS CONSTANTLY SOUGHT MORE FUNDING, HE HAS RESISTED MY HIGHER FUNDING RECOMMENDATIONS, NOT BECAUSE THE SEC DID NOT NEED THE MONEY, BUT BECAUSE HE IS A TEAM PLAYER AND CERTAIN ADMINISTRATION OFFICIALS URGED US TO HOLD THE LINE ON ALL AGENCY BUDGETS. WHATEVER FUNDS WE AUTHORIZED, YOU COULD BE SURE THAT THE SEC UNDER JOHN SHAD WOULD MAXIMIZE THESE FUNDS. THE 52ND ANNUAL REPORT OF THE SEC DEMONSTRATES THAT THE SEC'S OVERSIGHT ACTIVITIES HAVE GROWN FAR FASTER THAN ITS BUDGET. THE SEC SETS THE EXAMPLE OF EFFICIENCY AND ACHIEVEMENT WHICH OTHER FEDERAL AGENCIES SHOULD EMULATE.

HOPEFULLY, WE WILL HAVE AN OPPORTUNITY TO QUESTION CHAIRMAN SHAD AND THE OTHER WITNESSES ABOUT THE SEC'S CURRENT POSTURE ON LEGISLATIVE PROPOSALS ON INSIDE TRADING, TENDER OFFER REFORM, ONE VOTE/ONE SHARE AND MARKET INTEGRITY ISSUES SUCH AS PROGRAM TRADING.

Senator RIEGLE. Senator Hecht.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you very much, Mr. Chairman.

I would also like to welcome Chairman Shad, Mr. Anderson and Mr. O'Brien here today to testify on the SEC authorization request.

The SEC and Chairman Shad are to be commended for the job they have done in somewhat trying times. While many have criticized the SEC, I contend that given the proper resources they can continue to improve upon their oversight and enforcement activities.

Also, many contend that investor confidence has been permanently shaken by the recent insider trading scandals on Wall Street. Well, I believe that the evidence shows otherwise. Sure, we all realize there are problems, but we in Congress cannot and should not legislate in haste over what I feel are a few isolated cases.

To overregulate and legislate in an effort to address every problem that occurs in what are the most varied and vital capital markets in the world would be a big mistake. What we need to do is to allow the SEC to beef up its enforcement program, close the 10-day reporting window of schedule 13(d), and impose longer prison terms for violators of securities fraud.

I look forward to hearing the testimony of today's panel. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Hecht.

Chairman Shad, after hearing all these accolades, you may well have changed your mind and decided you want to stay for another several years at the SEC, but we would be happy to hear from you now.

STATEMENT OF JOHN SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. SHAD. I think I'd better quit right now. Well, I can't tell you how much I appreciate the advice and counsel that the full committee just under Chairman Garn and now under Chairman Proxmire and the subcommittee over the years under Senator D'Amato and now under you, Chairman Riegle, have provided to me. Your bipartisan support in major areas of concern and issues and legislation has been, in my opinion, a major contribution to the investing public of America. It wouldn't have happened but for the individuals here today.

The past 4 years have included the support and sponsorship of the Insider Trading Sanctions Act, the SEC-CFTC Accord, which resolved a 7-year turf battle between two Federal agencies; the Government Securities Act, the Shareholder Communications Act; and many other areas of major national concern.

On behalf of the Commission, the staff, and the investing public, I simply want to say thank you to you gentlemen for your leadership in this important area of the Nation's economy.

The SEC appreciates this opportunity to present an overview of its activities. It is requested that the formal statement and also the

authorization request previously submitted to the committee be included in the record.

Senator RIEGLE. It will be.

Mr. SHAD. With me today are Commissioner Cox and the senior members of the SEC staff who, as usual, have done an outstanding job of assembling the essential facts and materials which we will be discussing at this hearing. More important is their exceptional performance which we will be reviewing today.

GROWTH OF THE MARKETPLACE VERSUS GROWTH OF THE COMMISSION

Now, Chairman Riegle, with your permission, I would like to review briefly the four charts that you have before you. Each of you has a set of these. There has been a lot of discussion about the growth of the marketplace versus the growth of the Commission. We have tried to provide objective facts on a comparable basis. There's frankly a lot of misunderstanding and misperception in terms of what's been going on both within the marketplace and the SEC during the past 6 years.

The first exhibit, a pie chart (p. 16), sets forth the SEC's major program areas. To put the overall Commission activity in perspective, one-third of the staff is devoted to prevention and suppression of fraud, which is the enforcement program. About a quarter is devoted to the Full Disclosure Program. As you well know, publicly owned companies are required to make full disclosure to the investing public in their prospectuses and annual and other reports. These documents are selectively reviewed by the Corporation Finance Division. Problem situations are referred to the Enforcement Division.

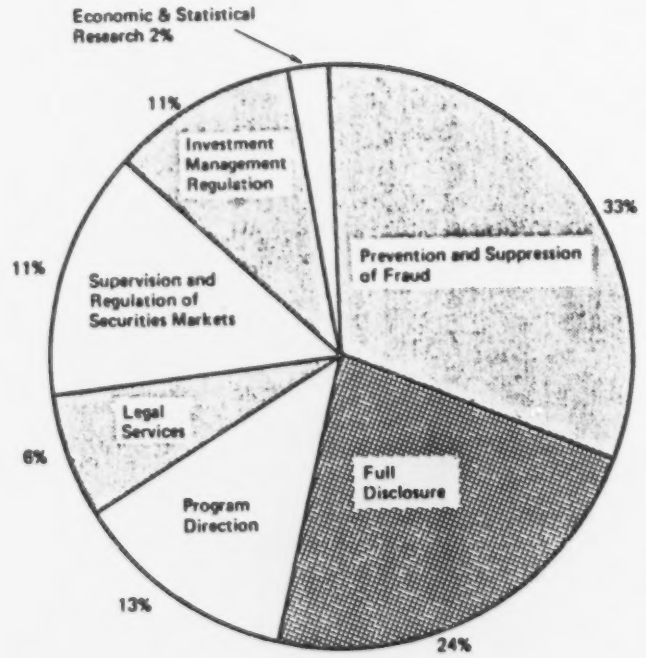
The next segment of the chart is program direction, 13 percent, which is for the support activities of the Commission, the running of the Commission. Legal service follows at 6 percent. The General Counsel's Office has an outstanding track record. During the past year, they prevailed in 86 percent of the 81 cases argued.

The next area, 11 percent is for the supervision and regulation of the securities markets. The Market Regulation Division is responsible for inspecting and overseeing the self-regulatory organizations, conducting oversight examinations of broker-dealers and many other activities, both domestic and international.

Next, 11 percent is for the Investment Management Division, which oversees and inspects investment companies and advisers and other activities. It is notable in this area that, while there have been scandals and problems in many segments of the financial services industry, we haven't seen them among investment companies and advisers. It is an area of continuing concern, but we haven't had major failures of any of the investment companies or advisers.

Finally, the 2 percent sliver is devoted to economic and statistical research.

FY 1988 Positions by Major Program



RECORD RESULTS

The next chart (p. 20), —and I think this is the most important piece of paper that I would like to leave with you today—is captioned "Record Results." It sets forth the SEC's results for each year since 1981. Through automation, paperwork reduction and other staff and Commission improvements, the SEC has achieved a succession of record results or the highest levels in years. The only reason we qualify it with "the highest levels in years," is simply because we don't have the data for all the prior years. I believe it's a record in the history of the Commission.

The far right-hand column is captioned "1981-86 Change" and sets forth the percentage increases between 1981-86. The first line is litigation. This shows the number of cases litigated, amicus positions, subpoena responses, and bankruptcy appearances by the Office of the General Counsel. These have been increased, as you see, from 121 in 1981 to 179 in 1986, a 48-percent increase. Looking down that right-hand column, you will see that enforcement actions have been increased 63 percent; filings reviewed during the year just ended were a record 10,526, a 71-percent increase over 1981; broker-dealer oversight examinations have been increased 73 percent. It was mentioned a moment ago that only 5 percent of broker-dealers are examined. Well, these are oversight examinations. All broker-dealers are examined on an annual basis by the self-regulatory organizations. The SEC staff has oversight. We get enormous leverage by using this highly professional staff to oversee huge organizations, including all of the stock exchanges and the National Association of Security Dealers that provide this annual review of the broker-dealers and many other areas. I will amplify this a little later.

The next line represents the self-regulatory organization, [SRO], inspections, which have been increased 83 percent. Investment company and adviser inspections have been increased by 155 percent per annum. The annual rate is now over 155 percent of the rate in 1981.

Not only has the volume of all of these activities been increased, but the efficacy, the quality of the reviews, examinations, inspections and enforcement actions have been increased by the staff by targeting problem areas. They used to go through a cursory overall review of all filings, which was not of great value. It's much more effective to identify specific problem areas through careful screening and focus on those and it will be much better under the electronic system. In any case, careful screening and targeting specific areas of concern coupled with staff specialization make the review process more effective. We now have people who are specialists in all the various industry categories. Through the use of microcomputers and sophisticated techniques and refinements, the quality of reviews has been increased. We're not only getting a larger volume, but better quality efforts by the staff.

The next two lines set forth authorized positions and staff years. I think this is a critical area that should be of our mutual concern.

As you see, authorized positions have been increased 3 percent, but staff years are down 4 percent. This difference is primarily due to budgetary constraints but also to wage disparities between the

Government and the private sector. Some of our authorized positions can't be filled simply because we are not competitive on salaries, on compensation. Accountants, lawyers, security analysts are in great demand. During this enormous bull market, the law firms, the security firms—I wouldn't say are raiding the SEC, but a huge portion of our staff turnover annually is due to the fact that these professionals leave the Government to dramatically increase their compensation by going with the leading law, accounting, and securities firms. In fact, we are constantly losing good people to the private sector.

The next line sets forth the SEC's annual budget. While many independent agencies' budgets have been reduced since 1981, contrary to a common misperception, the SEC's budget has been increased from $80 million in 1981 to $106 million in 1986, a 33-percent increase. Actually, the 1986 budget which was initially approved by Congress and the President was $111 million. But like everyone else, the Commission took a 4.3 percent Gramm-Rudman-Hollings cut, which brought it down to the $106 million set forth in the table.

SEC'S BUDGET INCREASED 43 PERCENT

At the request of the President, the Commission's 1987 budget restored the Gramm-Rudman-Hollings cut, plus an additional $3.4 million, bringing this year's fiscal 1987 budget to $114.5 million, a 43-percent increase since 1981, one of the largest increases of any independent agency.

All of us—Congress and the Nation—are very concerned about this huge Federal deficit and yet in the next breath it's sort of "Don't cut me. I want more." The SEC's budgets are submitted like all other independent agencies to OMB which reviews them in the light of the huge Federal deficit and other national priorities. The President then makes a recommendation which the Commission has consistently supported—not just this Commission but the past Commissions—and the budgets are set by the congressional committees and approved by the President. It's not within our purview to set our budgets. We make recommendations. We certainly defend our budgets which the President submits to this Congress.

In any case, as you see, our budgets are up through the current fiscal year 43 percent. The President has requested a $31 million, 27 percent, increase in the Commission's fiscal 1988 budget to $145 million to cover a 9-percent increase in authorized positions and the startup cost of the SEC's electronic disclosure system known as EDGAR, for Electronic Data Gathering, Analysis and Retrieval.

The $145 million 1988 budget is an 81 percent increase over 1981, which I believe is greater than any other independent agency.

The bottom line of the table shows that during the past 4 years fees, as a percentage of the budget, have significantly exceeded the budget.

In 1986, they were 203 percent. The fees were over twice the amount of the budget, and the surplus for 1986 amounted to $109 million. A substantial surplus is also projected for 1988 even after the requested 27-percent increase in the Commission's budget.

What the SEC has been doing over the past 5 years is increasing investor protection and reducing the effective costs to the private sector, which in fact is borne by the investing public. Activities by the Commission have reduced these costs by over $2 billion per annum for the benefit of investors. Regulation that is not cost-effective is a heavy burden on the economy and the investing public.

RECORD RESULTS:

IN FISCAL 1986 RECORD RESULTS OR THE HIGHEST LEVELS IN YEARS WERE ACHIEVED BY ALL DIVISIONS.

	FISCAL YEARS ENDED SEPTEMBER 30TH						1981-86
	1981	1982	1983	1984	1985	1986	CHANGE
LITIGATION	121	141	161	176	153	179	+48%
ENFORCEMENT ACTIONS	191	254	261	299	269	312	+63%
FILINGS REVIEWED	6,153	6,239	6,987	7,237	9,571	10,526	+71%
BROKER-DEALER OVERSIGHT EXAMS	278	249	324	389	447	481	+73%
SRO INSPECTIONS	12	19	18	20	21	22	+83%
INVESTMENT CO & ADVISER INSPECTIONS	748	1,065	1,085	1,334	1,606	1,906	+155%
AUTHORIZED POSITIONS	2,021	2,021	2,021	2,021	2,046	2,080	+3%
STAFF YEARS	1,982	1,881	1,921	1,885	1,940	1,898	-4%
BUDGET (000,000)	$80.2	$83.3	$89.7	$94.0	$106.4	$106.3	+33%
FEES AS A PERCENTAGE OF BUDGET	81%	94%	110%	129%	135%	203%	

Senator RIEGLE. Chairman Shad, let me just interrupt you at that point. We do have a vote that's occurring on the Senate floor. The second bells just rang. I'm going to suggest that we go over as a body as quickly as we can and come right back. It will give you a chance to maybe take a brief break here yourself and we'll hope to resume in about 10 minutes.

Senator SASSER. Mr. Chairman.

Senator RIEGLE. Senator Sasser.

Senator SASSER. Mr. Chairman, I would ask unanimous consent at this juncture that my statement be included in the record as if read.

Senator RIEGLE. By all means, it will be.

[Recess.]

[The complete prepared statement of Senator Sasser follows:]

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, the subject of today's hearing is extremely important. The Securities and Exchange Commission is charged with one of the most difficult tasks of any agency in our Government. Its current investigation and prosecution of the unfolding, massive insider trading scandal is highly laudatory and underlines the sensitivity of the SEC's mission. Insider trading, as Mr. Shad I am sure will testify, is a very diffcult crime to prosecute.

However, the current scandal raises questions in my mind as to how long this insider profiteering has been going on; as to how pervasive these activities are; and as to how much insider and other manipulative tactics have contributed to, and facilitated, the corporate takeover craze.

Frankly, I'm afraid the answer to all my questions is, "we've only seen the tip of the iceberg."

Consequently, I wonder, as I am sure my colleagues do too, if we are authorizing enough money for enforcement of existing securities laws. And if the SEC's monitoring of the markets is adequate. Basically, I wonder if we are doing everything we can to clean up this mess.

This isn't just an issue of public confidence in the stock market—although I recognize that declining confidence is an extremely important concern. Just as important to me, is the end result of a lot of this insider and manipulative activity.

It's increasingly clear that much of the insider abuse that the SEC is currently pursuing has taken place in the context of corporate takeovers. It's also very likely that the sharing of insider information and collusive activity have made some hostile takeovers much easier to accomplish.

This committee has heard much testimony on the takeover issue. Hostile takeovers have contributed to an enormous increase in corporate debt and have caused the "busting up" of many healthy and well-managed companies. Many jobs have been lost and many communities devastated—this is not a record to be taken lightly.

Mr. Chairman, the takeover issue is, I believe, one that this committee must address directly and decisively very soon. We must increase disclosure requirements and reduce filing deadlines. We must eliminate the abusive practices which have characterized the

process. And as has been recommended to us in prior hearings, we must increase the penalties for violations of our securities laws.

Mr. Chairman, I'm looking forward to the testimony of the distinguished witnesses you have assembled here. Thank you.

Senator RIEGLE. Let me ask everyone to find a seat and I want to explain what the situation is that's occurring on the floor. These are unanticipated situations that arise. We are in the midst of a very key parliamentary struggle between the leaders on either side and so we're going to have a series of roll call votes of which we are now in the midst of a second, and they will come pretty much one on the heels of another. So we're going to find that interruption.

In addition, the subway car between the Dirksen Building and the Capitol has gone out of commission, so it's not even easy to get back and forth quickly.

But having said all that, it's very important that we proceed today so we are going to shift to some ad hoc methods here as we need to.

What I would like to ask you to do, Chairman Shad--I know you've got a long presentation that you have been working on and I'd like you, as much as you can, to summarize it. We will put it all in the record obviously, but I want to make sure that we have time to get to an exchange back and forth and I know my other colleagues who will be coming and going as best they can manage feel the same way. So why don't I ask you now if you can to sort of touch on the highlights of what you want to say at the outset and then as quickly as we can we will move on to an exchange between ourselves.

I appreciate your understanding of the circumstances we're in.

Mr. SHAD. Thank you, Chairman Riegle, and I will be brief.

FIVE-YEAR RECORD

I would like to cover the next chart (p. 24), captioned "Five-Year Record," because there has been so much discussion about whether or not the SEC's efforts have kept pace with the rapid growth of the marketplace.

This series of comparative bar charts shows the percentage increases since 1981 through 1986 of each of the Commission's principal activities with the growth of the areas the Commission surveils.

The first bar is enforcement actions which, as you can see there, they have been increased 63 percent.

The next two bars cover the Full Disclosure Program, and, as you can see, the number of full disclosure filings have increased 35 percent, but the staff reviews have been increased by 71 percent, over twice as large a growth rate as the number of filings.

The next three bars indicate that the number of broker-dealers has increased 57 percent, but the oversight inspections of broker-dealers by the staff have increased 77 percent, and self-regulatory organization inspections have been increased by 83 percent.

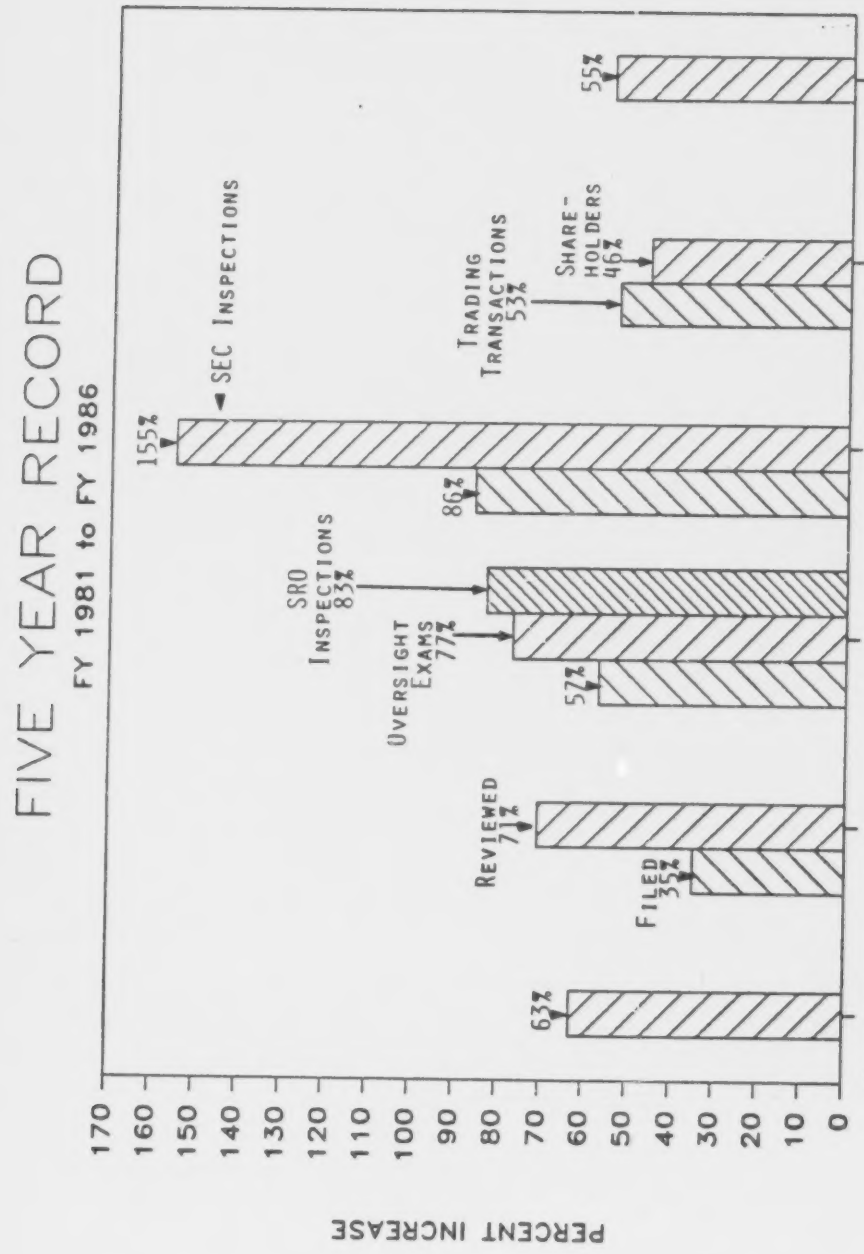
The next two charts show the growth of investment companies and advisers and the inspections by the SEC. The number of investment companies and advisers has increased 86 percent, but inspec-

tions of investment companies and advisers by the SEC staff have increased 155 percent.

Let me interject at this point that there's been an enormous increase in the daily trading volume on the New York Stock Exchange. It's up 186 percent. The number of transactions, however, has only increased 53 percent, and the number of shareholders has only increased 46 percent since 1981. As you look across the chart, you will see that every category of the SEC's activities has increased more than the transactions and number of shareholders.

The final bar is complaints at the SEC. They have increased 55 percent; but since 1982, all are reviewed. Most involve broker-dealer back office matters that are referred to the various firms' legal and compliance departments for investigation and written response and are tracked by the Commission through resolution. Others are referred to the Enforcement Division, the self-regulatory organizations, and others for further investigation and prosecution, if warranted.

I think this chart clearly demonstrates that the Commission's activities have grown at a favorable rate relative to the very impressive growth of the marketplace itself.

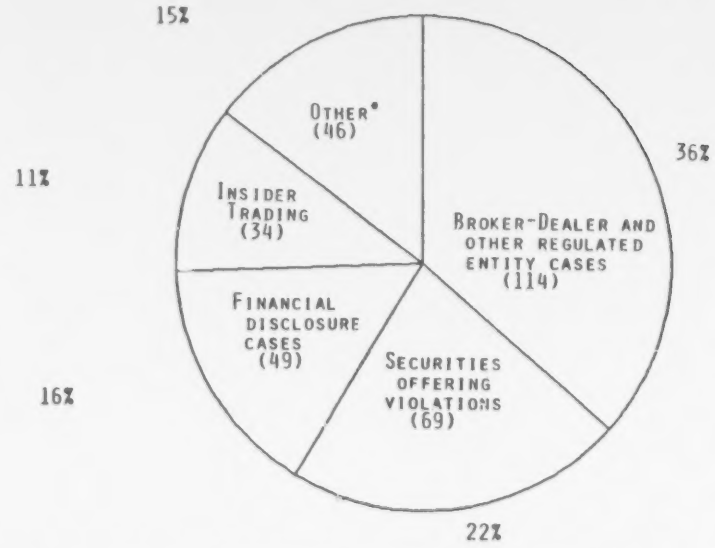

FIVE YEAR RECORD
FY 1981 to FY 1986
PERCENT INCREASE
0
10
20
30
40
50
60
70
80
90
100
110
120
130
140
150
160
170
63%
ENFORCEMENT ACTIONS
35%
FILED
71%
REVIEWED
FULL DISCLOSURE
57%
77%
OVERSIGHT EXAMS
83%
SRO INSPECTIONS
BROKER-DEALERS
155%
SEC INSPECTIONS
86%
53%
TRADING TRANSACTIONS
46%
SHARE-HOLDERS
INVESTMENT COMPANIES/ ADVISERS
55%
TRADING VOLUME
COMPLAINTS

The last chart (p. 26), is a pie chart that is intended simply to give an overview perspective of the SEC's enforcement actions. Broker-dealer and other regulated entity actions during the past year, 1986, accounted for 36 percent of the cases. You wouldn't think that from the headlines because the insider trading cases have gotten greater visibility; however, they only amounted last year to about 11 percent of the cases the Commission brought. They are running at a higher rate this year and may hit 20 percent. I don't think what the Commission is doing is generally appreciated. Some of these other cases, the financial disclosure areas, can be much more important than an individual insider trading case in terms of the consequences to hundreds of thousands of investors, but they do not get comparable visibility.

I think I ought to stop now and invite any comments or questions.

ENFORCEMENT ACTIONS

312 CASES IN FY 1986



ALSO, A RECORD $38 MILLION OF ILLICIT PROFIT DISGORGED; AND $4 MILLION IN FINES LEVIED.

* MARKET MANIPULATION
DELINQUENT FILINGS
CORPORATE CONTPOL

Senator RIEGLE. Well, thank you.

I am very much interested in terms of where we're going from here. I think this tells us the road we've been over, but as you leave at this point and review the dynamics, the trendlines of changes and the new circumstances in which we're being catapulted into, I'm interested in how you see the future. So let me pose some specific questions and then to the extent that it's relevant to make some observations along that line, I'd like you to try to give us some help with respect to a forward look as well.

Last month, Mr. Giuliani and Mr. Lynch, who is here with you today, testified here before the full committee that the current investigations being conducted at the Commission and at the U.S. attorney's office would lead to further prosecutions and major cases being brought. I'm wondering what you can tell us today about the timetable on any other cases that are in the works and what are the areas that you are devoting the most attention to at this time.

MAJOR ONGOING INVESTIGATIONS

Mr. SHAD. Well, he was referring I think almost entirely to the insider trading cases—certainly primarily so—and there are major ongoing investigations. It's often expressed as "when is the next shoe going to drop?" I think you will see a succession of shoes dropping through this summer. I hope it would be in everyone's interest if these major investigations could be brought, the charges made and settlements in some cases reached or cases going on to litigation by the end of the summer.

Senator RIEGLE. May I ask, without getting into specific instances, are we finding that the pattern of discoveries that are being made are broadening out in the sense that we're likely to see in the subsequent cases perhaps new kinds of cases or different kinds of cases in the sense of the scope and scale of what has been going on?

Mr. SHAD. Yes. In the course of these investigations, of course, there are new discoveries especially from cooperating witnesses. The staff vigorously pursues those wherever they lead, and they lead beyond insider trading in some cases.

Senator RIEGLE. One of the issues that we are working with here is that we are attempting to bring forward some legislative recommendations both on a possible new definition or a more clear definition on insider trading and, some issues that would relate to changes in the tender offer process.

And while we've pretty much completed our initial work to bring ourselves to a point of making legislative proposals, I'm very much interested in making sure that the general scope and scale of difficulties that are occurring out there are something that we have enough of a sense for that we don't go ahead and make proposals and then find that market developments in some way or another have created new and different conditions that aren't yet fully understood and that might be some number of months down the track.

So when the other witnesses were here, we were talking about the question of whether it looked as if there was any instance or did there seem to be the appearance in the kinds of difficulties that

were being discovered that, rather than being isolated instances in the classic case of somebody having an insider trading knowledge and then going ahead and acting in their own behalf, we were seeing situations perhaps arising where you had sort of a whole network of players involved so that the scale of the misconduct was not one or two or three people in a relationship but it may be a much broader kind of network and something that had grown up within the market trading system that was maybe quite different than what we have thought about in the past.

Are events leading us in that direction? Can you shed any light on that today?

Mr. SHAD. Yes. There have been already publicly exposed network situations involving Marty Siegel and others that are being prosecuted.

In 1981, Fortune Magazine and other leading publications were running articles indicating that insider trading was so pervasive nothing could be done about it, and I think a lot of people took those articles as licenses to engage in the activity. The attitude was, well, if everybody else is doing it, why not?

Also, there's been a dramatic increase during the past 5 years in tender offers, and the opportunities for insider trading have dramatically increased. In addition, I think the reason you've seen 125 cases brought during the past 5 years as compared to 77 during the previous 47 years is because of the significant improvements in the Enforcement Division's ability to expose and prosecute these violations.

Insider trading has not been eradicated, but it certainly has been inhibited by the cases that have been brought. As a consequence, the profits that Mr. Boesky and others have been siphoning out of the market are now flowing through to the investing public. The markets today are even better than they were yesterday, and they were by far the best markets the world has ever known yesterday.

INCREASINGLY DIFFICULT FOR INSIDE TRADERS TO HIDE

I think that a lot of these activities—networking and other type of activities—have been dramatically inhibited by all the publicity and concern. By the effectiveness of the Enforcement Division, these cases demonstrate that it's become increasingly difficult for inside traders to hide at home or abroad. Our enforcement is much more effective.

As often happens, the same concerns that we're seeing on the Hill are also present within the securities industry. The securities industry is very concerned. This adverse publicity is coming right out of their hides. They are in a business depending on public confidence—and on that score I have to say that the level of the markets indicate a very high level of public confidence. Some are concerned about the high level of the markets at the present time.

It may have been more pervasive yesterday—but I don't subscribe to the opinions expressed by others that today the activity is endemic or systemic throughout the securities industry. I think that's a reaction of the generals to the last war and not to the present reality.

Senator RIEGLE. Well, I think most of us that have looked at this are of the view that these are not endemic conditions and that the overwhelming number of people in the financial markets obey the law, follow the law, and are very sensitive to making sure they do so.

But having said that, I'm wondering, when you yourself acknowledge we've seen a lot of shoes drop already and when you indicate here today that there are a succession of shoes yet to drop, it does suggest that an awful lot was going on.

Now somehow that pattern developed to the point where there has been this burst of cases and, as you say, more cases coming, and I'm wondering what inference we should draw from that because it seems to me that they are not just narrow cases where a given individual went over the line. What we're seeing here, it seems to me, is something that is more pervasive than that.

I'm wondering what judgment do we draw from that in terms of what's been going on in the markets that would have suddenly created all these activities that we have now uncovered? Were they always going on and we just didn't know it or was something happening that caused a burst of that kind of activity which you and your enforcement people have now managed to track down?

I think the public wants to try to understand better why it is that all these shoes are dropping and why it is that we're suddenly now finding that there was this large scale of illegal activity going on. Help us understand this a little better, if you can.

Mr. SHAD. Well, in the most simplistic terms, the risk-reward ratio has been extraordinarily attractive to inside traders. The dramatic increase in the size of the dollars involved in tender offers, and the more complex these transactions have become exposing a greater number of people—lawyers and investment bankers and accountants—to the structuring of these transactions prior to public announcement has resulted in enormous abuse that we are now prosecuting.

I do think that there's been a tidal-wave-type reaction on Wall Street to these abuses. The headlines would suggest that the Street is rife with this kind of thing. But I get calls from the senior partners of major firms that are highly congratulatory. They want the Commission to do what it's doing. They have been a source of some of the most important leads. I also get calls from corporations. We've had really broad-scale public, financial, and business community support for what we are doing.

You've asked what more can be done, what should be done? Certainly a valid area of further inquiry for consideration of legislation would be a definition of insider trading.

It hasn't been defined and, contrary to some of the things I've read in the press, the Commission from the inception has been supportive and has wanted to come up with a definition, to have greater specificity. The problem has been that we haven't been able to get a consensus since I've been there either among the Commissioners nor the staff on a definition. It usually comes down to it's too broad or too narrow.

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When the Insider Trading Sanctions Act was being debated, or being supported actually, by Senator Wirth when he was in the House and by this committee, we sent to this committee three definitions, one just intended to codify what the cases were, another broader, and another more restrictive definition. The decision made by this committee, with the full support of the SEC and maybe at its recommendation, was "let's get on with it, we need the sanctions." It used to be that if you got caught you simply had to give back your profits, which wasn't much of a deterrent. We wanted the triple fine, the triple damages. The decision was made by this committee and the House as well to proceed with the legislation; and, in fact, the courts were not doing a bad job of defining on a case-by-case basis insider trading. Our concern is that a definition will result in a lot of relitigation, and redefinition of the terms. There's always concern about the criminal element going for the finite edges: those edges will in fact, however, inhibit all others who are not trying to lie, cheat or steal in the marketplace.

My feeling about a definition at this time is that I would like to have the benefit of the Supreme Court decision in the *Winans* case. It's a terribly important case. It involves one of the principal theories of insider trading sanctions, the misappropriation theory, which is not, however, as clearly defined as is the violation of a fiduciary duty by an officer or director of a company.

I think that case will be terribly important, and I would like to have the benefit of the Supreme Court's decision. Unfortunately, it will be argued in October, and you may not get the decision until the end of the year or early next year. The option would be to go for a definition now and try to anticipate or certainly define the issues that the Supreme Court will be addressing in that case.

Very few people argue about concerns as to the violation of a fiduciary duty when an officer or director of a company unloads his stock just before public announcement of bad news or tries to sweep up the public stock just prior to good news. In addition, there are derivative levels down through the organization of companies: the secretaries and others that are privy to that information. I don't think there is a real debate over those cases.

There is, however, a real debate over the misappropriation theory.

Senator RIEGLE. Let me stop you at that point. Senator Wirth wants to make some comments here and he has to preside shortly in the Senate. So let me acknowledge Senator Wirth and welcome him to the Banking Committee.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman.

Chairman Shad, I had wanted to come by. I think I was present at your first hearing in 1981 and this I believe is your last and I wanted to be here to thank you again for a job well done and to commend you and the Commission on extraordinary attention to a very difficult assignment. You have our very good wishes as you head off to the Netherlands.

I also wanted to put in my own word of commendation about your very generous gift and precedent to the Harvard Business School on ethics. Not being a business school graduate but knowing what an impact that particular gift should have not only on that school but on so many other institutions, we look for great multipliers coming out of that and I greatly appreciate your generosity.

If I might, Mr. Chairman, I think Chairman Shad has correctly described the history of the attempt to define insider trading. I think all of us wanted to see if that was possible. We had an American Bar Association group look at it and a whole lot of others, and I think you are accurate in saying we concluded at the end of a lot of discussion that we had to get on with the passage of the legislation.

I, myself, am quite skeptical about whether we are going to be able to come down with a definition of insider trading that isn't an open invitation perhaps to other kinds of abuses or might cause the reexamination of a great deal of litigation to date, and that we ought to be very cautious in trying to move in.

And I would, as I think most people who have had experience in trying to define that, understand how difficult it is.

The final note, Mr. Chairman. I think one of the most important areas in this whole area—and we don't have time to get into this at this point, but I would like to pursue it with the Commission in the near future—is the issue of self-regulation.

One of the glories of the markets in this country has been our capacity to regulate ourselves and, as a consequence of that, to induce a great deal of consumer confidence in the market. And I wanted to make sure that the Commission is examining the processes of self-regulation. I think that the markets have always respected that and respected the emphasis the Commission has placed on that.

And I wonder if there might be a productive area where the Congress, working with the Commission, might reach out and look at this whole area of self-regulation and that maybe there's an impetus coming from the Commission that would be welcomed by the exchanges, welcomed by the markets, to perhaps take a step more in self-regulation in examining the fabric of self-regulation which perhaps has become a bit frayed and maybe we need some greater attention to that.

Senator RIEGLE. If I may interrupt at this point because we're on the second of this vote—have you made the vote?

Senator WIRTH. No. I've only been listening to your extraordinarily pressing questions, Mr. Chairman.

Senator RIEGLE. I see. So we both have to make the vote. I'm going to use a procedure that we use on occasions like this. We will go over and vote. I assume there will be another vote immediately following this one, so we will make the two back-to-back votes, and I'll come back at that point.

I am going to ask staff counsel, Mr. Harris, if he will continue with a series of questions that I have here that I want to ask you so that we can go through some of the funding issues and so that we can have responses on the record and I hope to be back before he finishes with that because I would like to come back to some of the policy issues. We will not hold you for the full day and I again

apologize for the interruptions, but I want to proceed in that fashion so we make use of the time. I will be back here just as quickly as I can be and then we'll finish up and then we'll go on with the other witnesses.

So, Mr. Harris, let me ask you to come on up and continue the questioning at this point. Thank you.

FINANCIAL PLANNERS

Mr. HARRIS. Chairman Shad, the Commission's 1988 budget submission notes that registered investment advisers, including financial planners, have doubled since 1982 and now control assets amounting to 15 percent of all financial assets owned by Americans.

The budget points out that providing an adequate level of protection has become increasingly difficult as the number of registrants has grown and the budget describes possible alternatives under SEC consideration for regulation of this industry, including shifting responsibility to State authorities and creating a self-regulatory organization.

In the meantime, how will adequate oversight be provided until the SEC is able to set up suitable alternative mechanisms for overseeing financial planners, and what do you believe ought to be done in this area?

Mr. SHAD. Thank you. The Investment Management Division has refined significantly its ability to identify those financial planners that involve the highest level of risk, those that hold clients' money. Many financial planners do not. Investment management has identified the areas to investigate. Financial planners in those areas receive the principal investigatory effort and inspections to see that they are properly segregating the investing public's funds.

There has been an ongoing approach by the National Association of Security Dealers to come up with a self-regulatory organization within the NASD to handle these inspections and to do the things that it does in the broker-dealer area. It makes sense, in my opinion, since within the term financial planners we include investment advisers within the meaning of the Investment Advisers Act of 1940, and about 43 percent of these investment advisers are associated with or employees of the major broker-dealers subject to annual inspections by the NASD of its membership and the New York Stock Exchange of its membership. There is an ongoing consideration of creating an SRO which we do not now have in this area and we do have in the broker-dealer area. While I think that would be a very constructive move, I think that the Investment Management Division is doing a first-rate job of selective review and inspection of the financial planners.

This area has grown very rapidly. The division has also trained and worked with the State regulators. The vast majority of financial planners are only small firms, intrastate firms, that are properly, I think, the area of responsibility of the States.

Mr. HARRIS. That leads to a question on self-regulatory organizations.

Several witnesses recently appearing before this subcommittee have expressed concern about the ability of industry self-regulatory

organizations to meet the increasing regulatory burden shifted from the SEC.

These concerns relate to the limited legal authority of the organizations as well as resistance to the rising costs required to meet the oversight demands associated with new market volume and activities.

How do you respond to those who argue that you are asking the self-regulatory organizations to do too much in light of their limited legal authority?

Mr. SHAD. I've made several very affirmative statements about the outstanding job that the staff is doing in many areas, including the inspections, oversight and supervision of the self-regulatory organizations. In all of these areas, however, it's not perfect. More could be done.

In the case of the SRO's themselves, the size, volume and growth of the marketplace have put increasing burdens on them. They have been expanding their staffs and their organizations; and the New York Stock Exchange, one of the principal self-regulatory organizations, has come down with a whole series of requirements for its membership. The exchange proposes to require that member firms file annual and quarterly reports concerning their complaints, their activities, and any violations of the securities laws. This is another level of holding the firms accountable.

The first line of defense in most of these areas is the securities firms themselves, almost all of which have legal and compliance departments and computer reviews and systems to identify churning and other sales practice abuses which in turn are subject to disciplinary action by the SRO's.

I've got to say more can be done, but I think they are doing a very responsible job. They could do more, as we could.

Mr. HARRIS. What do you consider to be the main issues your successor as Chairman will have to address and when do you expect that person to be appointed?

Mr. SHAD. Regarding the latter, I would hope the sooner the better because I would like to be as helpful as I can to my successor before I leave.

The SEC and the Congress now have before them the heaviest agenda that they're ever had in my opinion, and I could cite some 20 major topics that will be the subject of your deliberations.

The two biggest areas I believe in terms of prospects over the balance of this decade involve the rapidly increasing internationalization of the securities markets and the application of telecommunications technology to the SEC's activities and the marketplace. We are literally on the verge of 24-hour trading in major companies' securities. Only about 500 companies have securities actively trading in more than one country, but I believe by the early 1990's we will see five times that many. The Commission has many ongoing efforts to identify and address areas of concern.

On the internationalization side, one starts with the imbalance of trade and payments, the less developed countries' loans, the dramatic increase in off-balance sheet bank guarantees, and swap arrangements which permit companies to borrow in one currency and repay it in another. Swaps have grown from $1 billion 4 or 5 years ago to $170 billion and banks' off-balance sheet guarantees of

these transactions. A liquidity crisis among any of the major players in those markets could have very serious adverse effects.

SEC'S AREAS OF RESPONSIBILITY

To come down now directly to the SEC's areas of responsibility in international markets, starting with the Swiss Accord in 1982, the SEC has implemented cooperation agreements with the United Kingdom, the Japanese, and the Canadian authorities, and others are contemplated. I think the ultimate evolution will be from bilateral to multilateral cooperation agreements.

Right now, with what we have on the table the agreements account for over 80 percent of world markets. There's more that has to be done in the area of international cooperation and enforcement matters. Also, access to markets, and the settlement and clearance of transactions are far from adequate on international trade. This area would create some very serious problems because of the inability of some markets to properly process their transactions in large volume.

The range is a couple of days in some areas in major markets to a month or longer in others, and with all kinds of attendant risks. The Commission is actively addressing these areas, and, this past summer, at the SEC's initiative, the International Association of Securities Commissions, which includes some 30 nations, unanimously supported the formation of multinational committees to accelerate response to these problems. The Commission itself is heading up one or two of these committees and other countries in the other areas.

Internationalization is a huge area, and I think there are enormous benefits. I want to emphasize that—while there are very immediate and important problems—there are enormous benefits from the increasing internationalization of the securities markets.

The other area is the telecommunications technology. The SEC is trying to play catch-up now. But for the very efficient telecommunication systems in the securities industry, there would be no way these markets could handle these 100 million share plus days back-to-back. They've become routine. When the volume gets down to 100 million, it's talked about as being a low volume. It wasn't very long ago, the 1960's or 1970's, when the marketplace couldn't handle a couple of 20 million share days back-to-back. This is a terribly important area within the Commission and certainly within the marketplace.

As I previously said, there is now a link between the United States and Canadian markets. Linkages are in process to exchange quotes between the United States and foreign markets. The dramatic growth in the international area is due to the high-speed, low-cost ability to execute these transactions.

One area that I think warrants comment because it's a mind-boggling fact that relates to the efficiency of the market and the integrity of the marketplace: The annual volume of transactions in corporate and Government securities last year amounted to nearly $40 trillion and that is done over the telephone—with my word as my bond, by a handshake. Three days later the paperwork follows.

There's enormous integrity in this industry and in the whole process. There's been nothing like it in the history of man. While there are areas of serious problems and concerns, they should be kept in perspective. The marketplace is incredibly efficient and fair. There are abuses that we have to address, but those are some of the areas of future concern.

Mr. HARRIS. We think that you and market regulation have been doing an extremely good job and I know that Mr. Ketchum's working on a report which will come back to the House and the Senate on this area and we certainly look forward to it.

I know my time has expired. Mr. Lykos is the Republican counsel and I think in all fairness he should have the opportunity to represent that side of the aisle with respect to additional questions.

SEC NEEDS LEGISLATION OF S. 1175

Mr. LYKOS. Chairman Shad, last Friday Senator D'Amato introduced a bill, S. 1175, which was provided by the SEC.

This legislation addresses the appellate court case that invalidated rule 3b-9 which the SEC promulgated in July 1985.

Why does the SEC believe it needs this legislation at this time?

Mr. SHAD. I'd like to use this question to table a much broader issue and then be specific.

Since the 1930's, the United States has had regulation of the financial services by industry classification, and it made enormous sense in years past. What has happened, however is that as a result of the growth of the financial service industry, new products and services, major mergers and acquisitions, providers are all into each other's backyards. The SEC since 1981 has been advocating functional regulation to eliminate the overlap, duplication and conflict between five different Federal agencies—bank regulators and the SEC—as well as over 100 different State regulatory agencies. We've got a haystack of regulatory overlap, duplication, and conflict.

What this proposed rule by the Commission, rule 3b-9, did was to recognize that a large number of banks are no longer providing brokerage services solely as an accommodation incidental to their trust management activities, as was contemplated when Congress enacted the 1933 act and 1934 act when it excluded banks from the definitions of "maker" and "dealer." They are broker-dealers today, at least a large number of them are, and the Commission's view is that the regulation and supervision of these banks engaged in brokerage activities should be under the same rules and regulations as everybody else providing competitive services. Banks are now running ads offering discount brokerage services.

The SEC has no desire to get into the internal regulation of bank activities, but it does believe that those brokerage activities should be set up in separate corporate affiliates and be subject to the same rules and regulations as everybody else engaged in those activities. The Commission applauds Senator D'Amato's initiative in introducing such legislation.

Mr. LYKOS. When the rule was in effect, did any banks register pursuant to the rule?

Mr. SHAD. Yes. Over 170 banks have registered. Even before the rule was proposed, banks were doing it as a practical business move. It often makes sense to bring in established securities firms to handle the transactions for the banks. There have been many. To my knowledge, notwithstanding the adverse appellate court decision in the District of Columbia as to the SEC's authority to impose such a rule, I'm not aware of any banks that have subsequently terminated their broker-dealer affiliates. It makes sense to consolidate those activities within such affiliates.

Senator RIEGLE. There will be other questions that Mr. Lykos has that he will want to put to you in a little bit, but in another break between votes here I want to come back to a matter that we were discussing before and I want to try to frame it a little more sharply if I can.

The burst of insider trading activity and the scale of the illegal activity that was going on has really I think been sort of shocking to everybody and I'm sure to yourself as well.

What I'd like to get your sense for is the degree to which we are uncovering or we may be uncovering a pattern of group activity where individuals in different parts of the financial services capital markets business are becoming involved in complex network type relationships to carry out insider trading violations time after time after time. In other words, that we saw a situation that maybe there are other historic precedents for it but I'm pressed to think of one on the scale that we have been seeing here.

And it seems to me from what you say, with more shoes to fall in the next few months, that what we may have here is something going on that is perhaps on a different scale than we've seen before.

RISK-REWARD RATIO

When I asked you about it before you said to the extent that that was true that maybe the risk-reward ratio encouraged that.

Well, I want to test that a little bit, too, because obviously then we need to do some changing in that area and we must make it more likely that people are going to get caught and I think the penalties for getting caught have to be substantially higher.

But without making those adjustments, the notion that the risk-reward ratio, if there are enough dollar signs hanging out there that people are willy-nilly—a large number of them and very prominent people are going to cross the lines into illegal action for whatever the purpose of the gain is, is really a pretty shocking indictment itself.

So I really want you to elaborate if you would on two issues. The first is, are we beginning to see some new pattern emerging here of this kind of group activity and collusion across different sectors in order to carry out repeated insider trading violations? Is that something that is now coming into view that would be, in a sense, new and different from what we've seen before?

Mr. SHAD. Some of the recent cases clearly demonstrate the group activity that you said has been going on. The economic incentives for that sort of activity are enormous. For example, we have seen Mr. Boesky with $50 million of illicit profits.

These recent cases have inhibited any formal or informal ongoing activities, because they have been shocking to those engaged in them although there's still a big economic incentive to engage in them. I think as our investigations proceed we will see other examples, but they will all relate to past events. The question is, does the marketplace respond to the demonstrated ability of the SEC and the Justice Department to expose and prosecute these activities?

Senator RIEGLE. What's the most important ways, in your view, that we could change the risk-reward relationship beyond just finding wrongdoing and prosecuting it?

Obviously, these people are smart people. They knew there was a chance they would get caught. They must have weighed the penalties or the risks of getting caught and the penalties they would pay if they were caught against the potential for gain, and they decided that they would go ahead and break the law.

How should we change the structure of risk and reward to alter that psychology in the future?

INHIBITOR OF INSIDER TRADING IS IMPRISONMENT

Mr. SHAD. Well, I think the greatest inhibitor of insider trading is imprisonment and that is not the SEC's side of the ledger, if you will. We are a civil agency. The criminal side is enforced by the Justice Department. These violations carry with them today up to 5 years' imprisonment.

The area that hits directly with the SEC on the imprisonment side of the ledger involves perjury and obstruction of justice in the course of our pursuing these cases. People have been sent to prison for perjury and obstruction of justice. Some have raised the question of whether sentences for perjury and obstruction of justice should be mandatory. I know Mr. Giuliani, who has done an outstanding job on the criminal side of the ledger, feels that there should be more, heavier imprisonment. I think that these crimes should be considered on a relative scale. I don't accept equating a threat to life to a white collar crime such as insider trading. It's terrible, but I think there is a justified distinction between the two in terms of imprisonment.

Senator RIEGLE. So your thought is that the reality of imprisonment would really adjust this risk-reward ratio more than any other single thing. I assume major financial penalties would also do that, where do you put that in relationship to imprisonment?

Mr. SHAD. Well, I think that fines up to three times the person's ill-gotten gains as well as three times the gains of his tipees--others to whom he's passed on such information—are an enormous financial consequence. We haven't gone for the full three times in the cases to date. I think there will be cases that will justify that heavy a fine. On the other hand, in most of these cases it bankrupts the individual involved so that I'm not sure that we need to talk about heavier cash sanctions.

There are other areas in terms of how the SRO's structured and enforced, the securities firms themselves, and the so-called Chinese walls that separate various activities within firms can be strengthened.

Senator RIEGLE. Now as I understand the logic behind what you're saying is that looking forward prospectively, if there's a much tougher likelihood of a stiff prison sentence that that's likely to deter somebody from crossing this line and going into illegal conduct. I guess that's what you're saying in terms of how we shut this down in the future is that we put that out there as a major disincentive and I suspect there's probably a lot of truth to that.

Let me go back one more minute to the group activity idea. Does it appear to you that in terms of the extent to which there have been group efforts to take and violate the insider trading laws that the group efforts in this area would be in a sense a single group that did it over and over again or are we talking about multiple groups or groups where the people involved were different from one situation to another?

I want to understand how pervasive this pattern may have become insofar as we now have a chance to see it and understand something about it. Are we talking about one group of people that did this time and time again or are we talking about multiple groups or are we talking about a group situation where the players were changing from one deal to the other?

Mr. SHAD. It is speculation on my part to conjecture about some areas in which we do not have ongoing investigations. I believe all three of the examples that you used have been in fact occurring. There have been networks, typically feeding the information to a key individual who in turn has taken advantage of it.

I think these networks have been informal—in fact, most of them I don't think are really formalized. I don't believe its organized criminal activity. These are highly sophisticated people. There are graduates of leading law and business schools involved. That's the shocking part of it.

I think all three of the examples you used have been going on. These cases are tough to make, and they are largely built on circumstantial evidence Whether or not you will be seeing cases that demonstrate all three is something I can't predict but I still think that the activity has been dramatically inhibited by the recent exposures. I also think that the rewards can be so enormous that it just requires enormous vigilance and ability to detect. The increasing internationalization of the securities markets has enormous benefits; but the high-speed telecommunications and multiple nominee accounts in foreign countries, in some areas that are not part of the cooperation agreements do afford unique and extraordinary opportunities to try to systematically take advantage of the markets, as you've suggested.

INTERNATIONAL INSIDER TRADING ISSUES

Senator RIEGLE. Well, the internationalization issue I think is a new one that's coming at us and I think it's very hard yet to fathom the full scope of challenges that that presents. We've found in a number of the insider trading cases that have already gone on that they were in many cases international in scope and scale in terms of information moving around, money moving around, buy and sell orders being placed off-shore and so forth. So the ability to detect that in a world market system, a 24-hour world market

system that's developing here, it seems to me poses a whole new challenge to our regulatory people and I'm frank to say I don't know that we yet understand quite the scale of that task. I don't know how comfortable you feel with where the SEC is today in girding itself to deal with those circumstances—not only to protect and find insider trading violations, but also to maintain fairness of the markets and give shareholders some assurance that the markets are working properly and so forth.

Where are we as nearly as you can tell us?

Mr. SHAD. In the internationalization area, we're very early in developing the infrastructure and the systems to do a better job of surveillance and enforcement of the laws. There's a lot of work that has to go on there.

Senator RIEGLE. I take it that you're saying that we're just really beginning in that area.

Mr. SHAD. Yes. It's just the beginning in terms of overview perspectives, but the Swiss Accord, an historic event in 1982, marked the first time that we had a way to remove the haven of the Swiss secrecy laws from inside traders. That's been followed with other agreements.

I think pretty impressive progress is being made and it's largely due to a cooperative attitude of not trying to impose U.S. law on foreign nationals, but by going to them and saying, "If people abuse your markets, we will cooperate with you in helping you ferret them out, and that's all we ask of you." We don't have what so many other countries do have, which are secrecy laws involving securities matters or blocking statutes.

An area that could help the SEC encourage more cooperation would be in our ability to make imformation available to foreign law enforcement groups so that we can in turn ask for information from them. I'm referring to materials that presently we have access to for our own purposes but where we are limited by our regulations and laws from making them available to foreign investigators.

Senator RIEGLE. I think that's a useful point. I don't know if we've gotten a recommendation on a change there, but I would welcome one from the SEC and let's see if we can't maybe take a step in that direction.

I do think the ability to exchange information is very important and we ought to nail that down before we sort of get overwhelmed by events that get ahead of us.

Let me ask you with respect to the growth in the number of registered investment companies and investment advisers, as I and others have said this morning, they've got hundreds of billions of dollars under management control and it's clear and the Commission has noted that these entities have become major financial intermediaries pretty much in the same category as banks, thrifts, and life insurance companies.

The Commission has also noted that the SEC is the primary regulatory body that oversees this industry. When I look at the budget request, the SEC has a staff of about 230 people and a total budget of about $13 million for this program with plans for a small increase, less than 10 percent in 1988, after no change at all between

1986 and 1987. I realize the Gramm-Rudman thing was—and I think improperly so—sort of cutting down on you at that time.

But I'm wondering, does the regulatory presence that we now have for this enormously large group of financial managers or investment managers and advisers—is our regulatory presence there at all equivalent to what it is in the case of banks or thrifts or life insurance companies?

Mr. SHAD. The record is a lot better.

Senator RIEGLE. Well, it may be now. I'm not concerned about how the record is now. I mean, the real test of that I suppose comes if you really find the market shaking itself and then you'll find out whether you're solidly footed or not.

I'm happy that the record has been good so far, but are you in a sense saying it's going to be just as good the next 5 years?

Mr. SHAD. Well, I don't think you're going to see a straight line projection of the growth that's occurring. I think it will be at a much slower rate over the next 5 years than it's been during the last 5 years.

ANNUAL INSPECTIONS AND REVIEWS

The Investment Management Division staff, however, has really come up with some very effective, dramatic improvements in the way in which investment companies and advisers are surveilled. Instead of using a shotgun, they've used a rifle. They have identified the high risk areas. One of the high risk or problem areas is net asset value. With money just pouring in, how do investment companies keep their books and keep them accurately and, of course, you worry about a run occurring on an investment company and the last ones out may not get their full value. That hasn't occurred. We haven't had a run and it's been a very effective regulatory system. But it can be better, and it is a heavy burden on the Investment Management Division. I think the response is that we need to do what we've done in the other areas, which is to get an effective self-regulatory organization to conduct these inspections and reviews on a more timely basis.

I'm not going to suggest, because I don't think it would be cost-effective, going back to the attempt to give a full inspection of the whole activity of an investment company or adviser on any kind of an annual basis. That would, I think, be prohibitively expensive and the ultimate cost would be borne by the taxpayers and the investing public. I wouldn't recommend it. I think the SRO approach is a lot more practical way to go about it.

Senator RIEGLE. Well, I'm certainly open to that point and I don't know that I've heard anybody suggest an annual audit of everybody that's in the business. I mean, that would be the extreme the other way and no one is looking in that direction.

But I'm wondering, just given the enormous growth, if we have the same sense of safety and soundness applying there that—you know, we go to some great lengths with respect to other kinds of financial intermediaries, if you will, to make sure that if they're hit with volatile market conditions and so forth whether they can sort of come on through and safeguard the capital that they are managing.

And I guess your testimony is to the effect that you feel quite confident about the fact that we are very solidly footed in that area now, that the monitoring that's going on, whether it's done within the industry or by the SEC, is fully adequate to what's needed. Is that what you're saying?

Mr. SHAD. Yes. I think that the serious problems that could occur in the future will be economically driven, not the result of abuses. Obviously, if you get a major break in the securities markets or in any segments—there are all kinds of specialized investment companies out there, high yield bond funds and various other categories—if you get a major break in the market and it causes a run, the same problem that banks have had—there are in place ways of dealing with those problems. In any case, the funds could become forced to liquidate in a down market, and that would have very serious consequences.

This is a very fundamental economic fact which I don't think is a practical area for the SEC to try to modify. In fact, you have periods of overoptimism and overpessimism in the securities markets. All the protective legislation in the world is not going to change human nature and I worry about bull market tops and the loss of confidence. What computerized arbitrage and hedging have done is to telescope into really a matter of minutes transactions that used to be spread over days and weeks. They are much more efficient. The marketplace is incredibly efficient. You can with confidence almost throw a dart at the New York Times listing of securities and say at any moment in time that the market is equating out the risks and the rewards of that investment. It's remarkably efficient.

The speed and the size of these markets however, and the transaction execution systems can cause high volatility. You could get a snowball effect building into a serious consequence.

Senator RIEGLE. When people talk about that—and a number have—about the possibility of a market meltdown because of this telescoping and that you get everybody coming through the door at the same time and all of a sudden you start to go down at an accelerating rate, is it feasible for that kind of thing to happen, in your view?

Mr. SHAD. I think there's an enormous panoply of reasons why something comparable to 1929 is incredibly improbable to occur under the present economic and regulatory environment. Nothing is impossible. The market broke, of course, from 1929 to 1932. Stocks fell 90 percent. The price level got down to 10 percent of what it was at the top. I think that there are an awful lot of reasons why that is highly, highly improbable. As for the meltdown theory, I just don't think it's likely.

Senator RIEGLE. Some have argued that given the number of market devices that are now being used to portfolio insurance and indexes of various kinds, triple witching hour and all the rest of it, that you could conceivably get a combination of events where, in the name of volatility, you might see the market in a given day not go up or down 150 or 200 points but maybe 500 points. Is that also beyond the realm of realistic possibility in your view, or should we steel ourselves to the fact that we are into a new condition with a different kind of market, with lots of new instruments, and that the prospect of that kind of thing could be real?

Mr. SHAD. In terms of probabilities of a 1-day break of 500 points of the Dow-Jones average? I would say I think it's highly remote, very remote. But I don't want to say anything is impossible. I think over a period of time you could well get a several hundred point reaction in the market. My Lord, it's been the broadest and strongest stock, bond, and new issue markets in history. It's been incredible, and historically they used to say that you could look for about a third reaction—a break about equal to a third of the prior price before a bull market reestablished its trendline upward. We haven't anything like a ⅓ reaction.

The thing that's been unique about this market in many ways is that it's risen to a new plateau and then sort of backed and filled for an extended period of time without this really major break occurring and gone on then to new highs.

Senator RIEGLE. Let me ask you just one other question and I appreciate your patience and your responses this morning, given the interruptions here especially.

At our hearing on February 24, 1987, we heard testimony that the Commission should be developing a vastly improved surveillance capability.

In 1985, the Commission abandoned one plan that it had to develop its own pervasive surveillance system, as you know. And I'm wondering—I don't know that it helps us too much to go back and find out why it was that that plan was not taken forward from 1985, but what is your view on the notion that we really need to see the development of an independent surveillance capability that goes way beyond where we are today?

MARKET OVERSIGHT SYSTEM [MOS]

Mr. SHAD. Well, it is a good starting point to talk about the Market Oversight System [MOS]. The SEC was developing a system which was duplicative of what was already going on at the New Stock Exchange and others in surveilling the markets. The Commission had a meeting with the heads of all the various exchanges and got an unqualified commitment of full cooperation and support. They would make available indications of abnormal market movements that may suggest a manipulation or insider trading.

I'm informed by the Market Regulation Division that we got full cooperation. Sometimes the problem has been that the marketplaces do not adequately screen for probable violations. We get a lot of information that is soft. We want hard facts that will give us a much better use of our own resources to screen because we've got to look at an awful lot of possibilities before we have a viable case.

We do have the full cooperation of the marketplace and today, we have electronic market surveillance systems in all the exchanges and the over-the-counter market, plus transaction audit trails that permit the quick identification of the source of the transactions which we didn't have a few years ago. There are major improvements going on in the SRO surveillance system, but I place high confidence in John Phelan's assessment of what they're doing and what more can be done because he's thoroughly

knowledgeable and dedicated to better markets, whatever can be done to improve them.

Senator RIEGLE. Well, I think he is and I admire too, what they've been doing, but that only covers a part of what goes on. An awful lot of market activity goes on that we would have to have another system in place to find.

Let me conclude this way. I have some other questions I'd like to give you to answer for the record if you would, and I know my other colleagues have as well and I want to, before leaving for this vote, be able to excuse you as a witness and call our GAO witness, and then I'm going to have the professional staff begin the questions there.

I want to say to you again, on behalf of this committee and the Senate as a whole, how much we appreciate your service over the length of time that you have been heading the SEC. This has been a difficult time. It's been a demanding time. It seems to me you have had a lot of new challenges to meet. You and your staff I think have done that with truly remarkable results.

I deeply appreciate and admire your personal commitment to public service and the fact that you are continuing it. I think it is the highest work around and there is lots of other important work as well, but the fact that you have devoted so much of your professional life this way has been a gift of service that is very much appreciated.

So in that same spirit, you have testified here today very directly and we value that as well. So let us wish you well in your future endeavors and I thank you for your testimony and for your service.

Mr. SHAD. Well, I certainly do appreciate those remarks and also I want to compliment you on the way you've taken over this terribly important area of congressional oversight and the agenda you have come up with. I think you are identifying the real issues, the difficult issues, and doing an outstanding job in the interest of the investing public in trying to improve the SEC's and the others' ability to do the proper job for the public. I would like to highly compliment you on the job you are doing. Thank you.

Senator RIEGLE. Well, thank you.

[The complete prepared statement of John Shad follows:]

STATEMENT OF JOHN SHAD,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES

CONCERNING THE COMMISSION'S AUTHORIZATION REQUEST
FOR FISCAL YEARS 1988-90

May 13, 1987

I. Introduction

Chairman Riegle and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to present an overview of its fiscal 1986 activities and its ongoing efforts. This statement also discusses the Commission's authorization request for 1988 - 1990. It is requested that the separate statement setting forth the SEC's 1988 - 1990 authorization request, submitted to this Subcommittee on April 9, 1987, be included in the record.

In fiscal 1986 the Securities and Exchange Commission increased investor protections and reduced unnecessary paperwork and other expenses, ultimately borne by investors. Highlights include:

Record results or the highest levels of performance in years were achieved by all Divisions (see table below). Over the past five years, through automation, paperwork reduction and other staff and Commission initiatives, the increase in the Commission's results has compared favorably to the growth in the marketplace.

For example, since fiscal 1981:

- Enforcement actions have increased 63%.
- Full disclosure filings by issuers have increased 35%. SEC reviews of these filings have increased 71%.
- The number of registered broker-dealers has increased 57%. SEC broker-dealer oversight examinations have increased 73% and Self-Regulatory Organization inspections 83%.
- The number of registered investment companies and advisers has increased 86%. SEC inspections have increased 155%.
- The number of shares traded on the New York Stock Exchange has increased 186%, but the number of transactions has increased only 53% because of the growth of large transactions by institutions and others. The number of investors has increased 46%.
- Complaints to the SEC have increased 55%. Since 1982 all are reviewed. Most involve brokerage back office matters. They are referred to the firms' compliance departments for investigation and written response, and are tracked by the SEC through resolution. Others are referred to the SEC Enforcement Division, the Justice Department, Self-Regulatory Organizations or state securities commissions for investigation and prosecution if warranted.

	Fiscal Years Ended September 30th						1981-86
	1981	1982	1983	1984	1985	1986	Change
Litigation ≠	121	141	161	176	153	179*	+48%
Enforcement Actions	191	254	261	299	269	312*	+63%
Filings Reviewed	6,153	6,239	6,987	7,237	9,571	10,526*	+71%
Broker-Dealer Oversight Exams	278	249	324	389	447	481*	+73%
SRO † Inspections	12	19	18	20	21	22*	+83%
Invest. Co. and Adviser Inspections	748	1,065	1,085	1,334	1,606	1,906*	+155%
Auth. Posns.	2,021	2,021	2,021	2,021	2,046	2,080*	+3%
Staff Yrs.ø	1,982	1,881	1,921	1,885	1,940	1,898	-4%
Budget (000,000)	$80.2	$83.3	$89.7	$94.0	$106.4*	$106.3#	+33%
Fees as a Percentage of Budget	81%	94%	110%	129%	135%	203%*	

* A record or the highest level in years.
≠ Cases litigated by the Office of the General Counsel, amicus positions, civil subpoena responses and bankruptcy appearances.
† Self-Regulatory Organization.
ø Authorized Positions and actual Staff Years. The differences are due primarily to budgetary constraints and also to government-private sector wage disparities.
After a $4.8 million reduction from the $111.1 million appropriated due to Gramm-Rudman-Hollings, which was restored at the request of the President in fiscal 1987.

II. Authorization Request for 1988-90

A. Description

The Securities and Exchange Commission seeks a three-year statutory authorization for appropriations in the following amounts: $153.9 million for 1988, $169.0 million for 1989, and $181.1 million for 1990.

Since its creation in 1934, the Commission has played a major role in protecting the integrity and sound operation of the nation's securities markets for the benefit of investors. The Commission strives to fulfill this important responsibility in the most effective and efficient manner possible, so that investors receive the most benefit from the Commission's programs at the least cost to them, their companies and taxpayers. Facilitating capital formation and accommodating market changes require long-range planning, extensive study, and carefully measured implementation. A three-year authorization will strengthen the Commission's ability to plan and carry out its programs.

B. The President's 1988 Budget Request

The authorization request is based on the 1988 appropriation request of $145,036,000, which represents a 27% increase over the 1987 appropriation, as proposed to be amended. The appropriation request includes 2,26 staff positions, a 9% increase over 1987. The funding requested includes approximately:

- $43.8 million for enforcement operations (30%);
- $26.1 million for the full disclosure program (18%);
- $21.7 million for electronic filing (15%);
- $15.4 million for market regulation (11%);
- $13.3 million for investment management regulation (9%); and
- $24.7 million for legal, economic, and support services (17%).

The 181 additional personnel requested are for the following efforts:

- 73 for prevention and suppression of fraud (40%);
- 50 for full disclosure (28%);
- 17 for investment management regulation (9%);

- 15 for program direction (8%);
- 12 for market regulation (7%);
- 9 for electronic filing (5%); and
- 5 for legal and economic services (3%).

Thus, the largest portion of the Commission's staff is allocated to its enforcement program. In fiscal 1987, the Commission authorized the hiring of 33 additional personnel for this program. In fiscal 1988, the Commission proposes to add 73 positions, 46 of which are slated for the regional offices. In 1987 and 1988 the Division of Enforcement in Washington plans to complete the staffing of a third associate director group. Regional office enforcement staffs will increase by 11%. The increased staff will be complemented by a 40% increase in mi rocomputer workstations and specialized software.

The President's budget requests $20 million in 1988 to cover startup costs of the operational electronic disclosure system known as "Edgar." The primary purpose of Edgar is to increase the efficiency and fairness of the markets for the benefit of investors, issuers and the economy by reducing from days and weeks to minutes and hours the public dissemination of time-sensitive corporate information. This will increase the utility of such information to investors, accelerate issuers' access to the market and increase their financing flexibility. Edgar will also assist the Corporation Finance and Investment Management Divisions in improving the efficiency, breadth and quality of their filing reviews and the Enforcement Division in its investigations.

The funds earmarked for Edgar's startup costs will enable the Commission to reimburse the contractor for actual expenditures incurred in connection with the acceptance and review system and for the portion of the receipt system required for the Commission's internal operations. The Commission's staff is currently reviewing the bids received for the operational Edgar contract. The terms and conditions of the contract will determine actual expenditures. Should the Commission not spend the full $20 million in 1988, it will not draw down any unused portion and will request that it be reappropriated later in the life of the eight-year contract. Over those eight years, 1987-1994, the Commission intends to reimburse the Edgar contractor $46.5 million. The 1988 authorization request includes an estimated 69 staff years

for Edgar management, contract administration and filer support and, based on partial time allocations, an estimated 58 staff year equivalents for the Divisions of Corporation Finance and Investment Management during the transition to Edgar.

C. Authorization Level for 1988

The funding levels in the 1988 authorization request generally address mandatory increases to the agency's current activity level plus workload generated by potential new legislation. There are a number of legislative proposals, including those concerning bank securities activities, tender offer regulation, and insider trading. Congressional consideration of these legislative proposals will require substantial Commission resources, and enactment would increase Commission responsibilities.

D. Authorization Level for 1989

In 1989, banking legislation which may be enacted in 1987 or 1988 would have a major impact if banks or their affiliates are permitted to enter broader segments of the regulated securities industry. All program areas would be affected by these increases in the regulated population. The government securities dealers newly regulated in 1987 would also create additional demands for resources in 1989.

The 1989 authorization level includes $15 million ($5 million less than 1988) for the Edgar operational system. This will be sufficient to accommodate the cost reimbursement contract, including the commitment that funds be available in any single year to cover the SEC's actual costs of system construction and operation. As in 1988, the total authorized level for Edgar may not be required to finance the Commission's portion of the system.

The continuing internationalization of securities markets, combined with continued growth and complexity in the domestic markets, is expected to require increases in inspections, enforcement actions, and rulemaking.

The 1989 pay raise is estimated at 3% for nine months in 1989. Inflationary economic assumptions account for 3.5% of nonpersonnel costs in 1989. Both the pay raise and inflation factors are based on Office of Management and Budget projections.

E. Authorization Level for 1990

In 1990, a continued increase in the regulated population would require added staff to review registrations and reports, provide legal and interpretive advice, conduct broker-dealer, SRO, investment company and adviser inspections and examinations, and institute enforcement actions. Similarly, transnational trading, enforcement, and information exchange are expected to increase, thereby affecting the regulation, enforcement and full disclosure programs.

SEC staff resources devoted to Edgar in 1990 will continue at the 1989 level. The labor-intensive activity associated with the transition from the pilot, implementation of the operational system, providing training and support to first-time filers, and instituting the administrative and management system to oversee the project are planned to be completed in 1990. Thereafter, fewer staff will be needed to provide filer support and training.

The 1990 authorization request includes $10 million for the operational contractor, $5 million less than 1989. Just as the 1989 funding for Edgar needed to anticipate the actual costs of the system, 1990 is also structured to accommodate actual expenditures for SEC operations. In both 1989 and 1990 only those funds needed for actual expenses will be drawn against the authorized level.

As in 1989, OMB has provided pay raises and inflation factors. The pay raise is estimated at 3%. The inflationary economic assumption amounts to a 3.3% increase for non-personnel costs.

F. Multi-Year Justification

The budget process has required the Commission's senior staff to plan beyond the current year. The Commission has supported multi-year authorization legislation consistent with other Executive branch agencies as an effective method of managing program and administrative structures.

A three-year authorization will strengthen the Commission's ability to plan and carry out its programs, including, for example, the Edgar electronic disclosure system, the integration of office automation systems and the surveillance, enforcement and other demands of the growing domestic and international securities markets.

The operational Edgar system involves a commitment by the SEC and the Office of Management and Budget to support the project for eight years -- 1987 through 1994. The contractor must also commit personnel and financial resources for the entire period.

In addition, the Commission is making long-range plans for automated support for investigations and litigation. The Commission has long recognized the benefits of automation. Until now, it has emphasized mainframe systems services, augmented by microcomputers which provide specialized and localized computer capabilities. While this approach benefits the recipient organizations, it does not provide the substantial benefits to be derived from the introduction of automation to office management. As part of the

SEC's overall automation plan, the Commission plans an integrated office automation system. A limited pilot system beginning in 1988 will test various hardware and software configurations.

International agreements regarding trading, information linkages and cooperative enforcement require long-term commitments. A three-year authorization will demonstrate this nation's commitment to resolve these and other problems.

III. Insider Trading and Related Cases

A. The Commission's Enforcement Program

During fiscal 1986 and continuing in 1987, the Commission has devoted substantial enforcement resources to its insider trading program. "Insider trading" refers generally to the act of purchasing or selling securities, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material nonpublic information about an issuer or the trading market for an issuer's securities. Provisions of the federal securities laws prohibit such trading not only by corporate officers and directors and other persons having a relationship of trust and confidence with the issuer or its shareholders, but also by persons who misappropriate material nonpublic information from sources other than the issuer. The tippees of any such persons may also be subject to the prohibition.

Insider trading is difficult to detect and even more difficult to prosecute. Unlike an investigation of a crime such as bank robbery, where enforcement authorities generally know at the outset that an illegal act has been committed, insider trading investigations typically are commenced to examine suspicious trades or trading patterns that may indicate a violation of the law, but may also reflect legitimate trading. Despite difficulties in obtaining evidence, the Commission's ability to detect, prosecute and deter insider trading has improved over the past five years. There have been significant improvements in the electronic surveillance capabilities of the securities exchanges and the NASD.

The Commission has also improved its ability to obtain evidence from foreign countries, utilizing both mutual assistance treaties and less formal memoranda of understanding with foreign governments. Agreements have been implemented with Swiss, Canadian, Japanese and United Kingdom authorities. In addition, broader treaties have been signed with the Cayman Islands and Canada in the last year. While the Commission has consistently assisted foreign governments investigating violations of their own laws, it is important to note that the Commission cannot assist foreign governments by exercising its authority to compel the production of evidence unless there has been a parallel

violation of the U.S. securities laws. The Division of Enforcement is currently considering proposing legislative amendments to address this situation.

Since 1981, the Commission has brought 129 insider trading cases, as compared to 77 during the prior 47 years. During fiscal 1986, the Commission brought 30 insider trading cases, as compared to 20 cases in 1985. 1/ Moreover, the cases instituted in fiscal 1986 and thus far in fiscal 1987 include many of the largest and most significant cases in the Commission's history. A brief summary of some of the Commission's recent insider trading cases follows. 2/

1. SEC v. Dennis Levine, et al., 86 Civ. 3726 (RO) (S.D.N.Y. 1986)

On May 12, 1986, the Commission brought one of its most important insider trading cases against Dennis Levine, a New York investment banker. The Commission alleged, among other things, that Levine made $12.6 million over a six-year period by insider trading in the securities of at least 54 issuers using information learned through his employment about actual or proposed tender offers, leveraged buyouts, mergers, and other business combinations. Levine consented to a permanent injunction against future securities law violations and agreed to disgorge $11.6 million in illicit trading profits. He also agreed to an administrative order barring him from the securities business and to cooperate with the Commission in its investigation. At the same time, he pleaded guilty to one count of securities fraud, two counts of tax evasion, and one count of perjury. Levine is presently serving a two-year sentence in a federal penitentiary.

The Commission's continuing investigation of Levine's activities led to cases against other investment bankers and a lawyer, who allegedly misappropriated information from their firms, passed it

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1/ For statistical reporting purposes, the Commission classifies each enforcement action under one program area. During fiscal 1986, in addition to the 30 insider trading cases referred to in the text, there were four cases classified in other program areas that also involved allegations of insider trading.

2/ For a more complete discussion of these cases, see Statement of Gary Lynch, Director, SEC Division of Enforcement, Before the Senate Committee on Banking, Housing, and Urban Affairs (Apr. 22, 1987).

to Levine, and traded on information he provided to them. 3/ These individuals have agreed to pay $3.7 million in disgorgement and $875,000 in civil penalties. Each has also pleaded guilty to securities fraud or tax evasion charges.

2. SEC v. Ivan F. Boesky,
86 Civ. 8767 (S.D.N.Y. 1986)

The Levine investigation also led to the largest insider trading case in history, instituted on November 14, 1986, against the arbitrageur Ivan F. Boesky. In settling that action, Boesky consented to a permanent injunction and agreed to pay the equivalent of $100 million in cash and assets. Boesky disgorged $50 million of illegal profits in cash and surrendered securities valued at $50 million as a civil penalty. Boesky also consented to an administrative order barring him from the securities business and agreed to cooperate fully in the Commission's continuing investigation.

The Commission alleged that Boesky received information from Levine and had agreed to pay him for it. However, the Commission filed its complaint against Levine before he received any money from Boesky.

On April 23, 1987, Boesky also pleaded guilty to a felony charge of conspiring to file a false Schedule 13D with the SEC. He is awaiting sentencing.

3. SEC v. Martin A. Siegel,
87 Civ. 0963 (S.D.N.Y. 1987)

On February 13, 1987, the Commission sued Martin A. Siegel, another New York investment banker. The Commission alleged that Siegel passed confidential information acquired through his employment to Boesky and that Boesky traded on it. According to the complaint, Boesky had also agreed to compensate Siegel, and in fact made substantial secret cash payments to Siegel. Siegel entered into a consent decree in which he agreed to disgorge his entire ownership interest in the securities of the investment firm at which he was employed, his interest in partnerships sponsored by that firm, and cash and cash equivalents in the amount of approximately $4.25 million. Siegel further consented to a permanent injunction against future violations of the antifraud provisions of the securities laws and to an administrative order barring him from association with a broker or dealer. Siegel agreed to cooperate fully in the Commission's continuing investigation. He also agreed to plead guilty to criminal charges.

3/ SEC v. Robert M. Wilkis, et al., 86 Civ. 5182 (S.D.N.Y. 1986); SEC v. Ira B. Sokolow, 86 Civ. 5183 (S.D.N.Y. 1986); SEC v. David S. Brown, 86 Civ. 7774 (S.D.N.Y. 1986); SEC v. Ilan K. Reich, 86 Civ. 7775 (S.D.N.Y. 1986); SEC v. Randall Cecola, No. 86-9735 (S.D.N.Y. 1986).

4. SEC v. Boyd L. Jefferies, et al.
87 Civ. 1804 (S.D.N.Y. 1987)

On March 19, 1987, the Commission brought an action against Boyd L. Jefferies ("Jefferies"), Jefferies & Co., Inc. ("Jefferies & Co."), a broker-dealer, and Jefferies Group, Inc., its parent company. Although this was not an insider trading case, it arose out of the Commission's Boesky investigation. The Commission alleged that the defendants violated the federal securities laws by market manipulation and by "parking" securities. As to the former, the complaint alleged that Jefferies entered into an arrangement with another person for whom he agreed to effect a series of transactions to support the price of a specific security so that trading in it would close at a certain price. The other person agreed to protect Jefferies & Co. from any losses it might incur from subsequently selling the securities.

With regard to the "parking" of securities, the Commission alleged that Jefferies agreed to make sham purchases of securities from Seemala Corp. ("Seemala"), a registered broker-dealer controlled by Ivan Boesky. Jefferies agreed with Boesky that Jefferies & Co. would hold the securities for Seemala and that Seemala would "buy" back the same securities shortly thereafter, take any profit or loss on the transactions, and compensate Jefferies & Co. for its cost of carrying the securities. The complaint alleged that the defendants thereby aided and abetted Seemala's violations of the Commission's net capital regulations, as well as violating or aiding and abetting violations of (1) beneficial ownership reporting requirements under Section 13(d) of the Exchange Act by failing to disclose membership in a group with Boesky; (2) books-and-records and filing requirements for brokers and dealers and public companies, by concealing information concerning the securities transactions and related agreements; and (3) margin requirements by, in effect, extending and receiving unlawful credit on the securities.

Each defendant consented to an injunction against future violations. Jefferies also consented to an administrative order barring him from the securities industry for at least five years. He also pleaded guilty to a felony charge.

5. SEC v. The First Boston Corp.,
86 Civ. 3524 (PNL) (S.D.N.Y. 1986)

In its case against the First Boston Corporation, brought in May 1986, the Commission alleged that the securities firm had engaged in unlawful trading for its own account, while in possession of material nonpublic information received from an investment banking client. First Boston allegedly received confidential information from a corporation concerning a forthcoming announcement

of a $1.2 billion addition to the corporation's property-casualty loss reserves. First Boston then placed the corporation on its restricted list, thereby restricting the firm from trading in the corporation's securities. In addition, First Boston's "Chinese wall" procedures prohibited the communication of this information to its trading department. Nonetheless, a First Boston insurance analyst told persons in the firm's trading department, who then disregarded the restricted listing, sold the corporation's stock, and purchased put options.

Without admitting or denying the Commission's allegations, First Boston consented to a permanent injunction against future violations, agreed to disgorge alleged illegal profits of $132,138, to pay a $264,276 penalty under the Insider Trading Sanctions Act, and to review and report back to the Commission on improving its "restricted list" and "Chinese wall" procedures.

6. Other Cases

The Commission has brought numerous additional insider trading cases in the past year. For example, several large cases, unrelated to the actions discussed above, have been brought alleging insider trading stemming from information improperly obtained by employees of investment banking or law firms. 4/

Many Commission investigations, in addition to those discussed above, have also led to criminal prosecutions of inside traders. One significant recent example concerned an insider trading group involving Michael David, a former associate of a New York law firm. 5/ All five defendants in that case have pleaded guilty to criminal charges.

B. Liability of Securities Firms for Insider Trading by Employees

Existing law provides that a firm may be liable for its employee's misconduct in certain circumstances. The issue turns on the particular facts of the situation, including whether the firm had adequate procedures designed to prevent and detect misconduct, whether it enforced such procedures, and whether the improper trading was done for the firm's or the individual's account.

4/ See, e.g., SEC v. Harvey Katz, et al., 86 Civ. 6088 (S.D.N.Y. 1986) (Commission obtained $2.1 million in disgorgement and $2.2 million in civil penalties); SEC v. Israel G. Grossman, et al., 87 Civ. 1031 (S.D.N.Y. 1987) (a pending case in which the Commission is alleging insider trading profits of approximately $1.5 million).

5/ See U.S. v. Andrew Solomon, 86 Cr. 451 (GLG) (S.D.N.Y. 1986); U.S. v. Daniel J. Silverman, 86 Cr. 452 (GLG) (S.D.N.Y. 1986); U.S. v. Robert Salsbury, 86 Cr. 453 (GLG) (S.D.N.Y. 1986); U.S. v. Michael David, 86 Cr. 454 (JFK) (S.D.N.Y. 1986); U.S. v. Morton Shapiro, 86 Cr. 455 (GLG) (S.D.N.Y. 1986).

Under Section 15(b)(4)(E) of the Exchange Act, the Commission may sanction a broker-dealer for the acts of its employees, if the firm has "failed reasonably to supervise" employees who commit violations. The Section provides that the firm will not be liable for a failure to supervise if it can establish that: (1) it had in place procedures that can reasonably be expected to prevent and detect violations and a system for applying the procedures and (2) the firm has reasonably fulfilled its obligations under these procedures, without reason to believe that the procedures were not being complied with.

In addition, a firm may have direct liability under Section 10(b) and Rule 10b-5 if an employee trades for the firm's account while in possession of material nonpublic information. In such cases, the trading is the firm's, and the employee's knowledge may be imputed to the firm.

The Commission has stressed the importance of establishing and following procedures to prevent misuse of information within a securities firm. While the Commission has not suggested that an impregnable "Chinese wall" is necessary, 6/ it has encouraged the use of procedures designed to prevent the misuse of material nonpublic information. 7/

6/ The Commission recognizes that investors and corporations benefit from the combination of expertise and facilities provided by multi-service firms. See In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 SEC Docket 933 (1968). The Commission accepted an offer of settlement in which Merrill Lynch agreed to establish a Chinese wall policy prohibiting anyone in the underwriting division from disclosing material nonpublic information obtained in investment banking to others within the firm, except, where necessary, to perform the investment banking activity.

7/ For example, Rule 14e-3, which prohibits certain securities trading while in possesion of material nonpublic information concerning a tender offer, provides that an institutional trader does not violate the rule if: (1) the person who made the investment decision for the institution did not know the material nonpublic information; and (2) the institution had implemented reasonable policies and procedures to ensure that individuals who make investment decisions for the institution do not learn material nonpublic information or trade while in possession of such information.

Finally, broker-dealer firms also may be subject to private actions for damages resulting from insider trading. Recently, there have been a number of multimillion dollar damages actions brought against securities firms and others by bidders alleging that insider trading increased the price paid to acquire corporations. 8/

IV. Tender Offers

A. Overview

The Williams Act Amendments to the Securities Exchange Act of 1934 comprise the principal federal regulation of tender offers and disclosure of substantial acquisitions of publicly-traded equity securities. 9/ The Commission's ability to address abuses under the Williams Act and the proper scope of federal regulation generally have been the subjects of continuing Commission review. Where the Commission has determined that reform or clarification of certain aspects of the law is desirable, it has made legislative recommendations, undertaken rulemaking, participated as amicus curiae in private cases presenting novel or important issues, or, where it believed the law has been violated, has filed enforcement actions.

8/ See, e.g., Anheuser-Busch v. Thayer, et al., 86 Civ. CA3-85-0794-R (N.D. Tex. Aug. 19, 1986) (denying motion to dismiss action by bidding company alleging that defendants' trading on misappropriated nonpublic information concerning the proposed transactions caused price rise in the target company's stock); Litton Industries, Inc. v. Lehman Brothers Kuhn Loeb Inc., et al., 86 Civ. 6447 (S.D.N.Y. 1986) (investment banking firm sued by client for securities fraud, negligence, breach of contract, and breach of fiduciary duty in connection with unlawful trading by Dennis Levine and others). But cf. FMC Corp. v. Boesky, No. 86-C-9879 (E.D. Ill. dismissed Apr. 16, 1987) (district court concluded that FMC lacked standing to allege that it paid too much to its own shareholders in recapitalization as a result of Boesky's insider trading).

9/ The Williams Act, enacted in 1968 and amended in 1970, added Sections 13(d), 13(e), 14(d), 14(e), and 14(f) to the Securities Exchange Act. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454; Act of Dec. 22, 1970, Pub. L. No. 91-567, 84 Stat. 1497 (codified at 15 U.S.C. 78m(d)-(e) and 78n(d)-(f) (1970)).

On July 31, 1986, the Commission issued a concept release soliciting public comment on three specific issues related to takeovers and contests for corporate control. 10/ The concept release sought comment on whether the Williams Act should apply whenever a person acquires a substantial percentage of a target company's securities during or shortly after the expiration or voluntary termination of a tender offer, 11/ whether there should be a governmental response to the proliferation of "poison pill" plans, and whether the Commission should adopt a self-governance exemption to certain provisions of its tender offer rules. The comment period ended on December 1, 1986. The Commission staff has been reviewing the comments received to evaluate whether a regulatory response to these issues is necessary or desirable. The Commission recently published a summary of comments.

B. Current Legislative Proposals

There are currently a number of proposals to amend the Williams Act provisions of the Securities Exchange Act of 1934. Several of the most significant issues raised by those proposals are discussed below. 12/

10/ See Securities Exchange Act Release No. 23486 (July 31, 1986).

11/ The inquiry was a response in part to recent court decisions holding that purchases of a target company's shares during or shortly after a tender offer fall outside the scope of the Williams Act. See SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985) (the Commission sued Carter Hawley alleging that the issuer purchase program constituted an unconventional tender offer that should have complied with the Williams Act and the regulations thereunder; the Ninth Circuit rejected the Commission's position); Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985) (the Commission filed an amicus brief arguing that Hanson's bid termination and immediate private purchases raised sufficiently substantial questions under the Williams Act to justify a preliminary injunction; the Second Circuit did not agree).

12/ On April 2, 1987, Commissioner Charles C. Cox testified on behalf of the Commission before the Subcommittee on Antitrust, Monopolies and Business Rights of the Senate Judiciary Committee concerning federal regulation of tender offers. His testimony centered on the most recent proposals for reform of existing federal regulation of tender offers. Although the Commission has not yet considered the specific proposals before the Senate in the 100th Congress, it has studied many of the issues and taken positions on prior, similar proposals, or addressed these issues in other contexts. His testimony set forth the arguments for and against various proposals presently under consideration. Accordingly, this testimony will not discuss these issues in detail.

1. Section 13(d)

The purpose of Section 13(d) of the Securities Exchange Act of 1934 is to provide adequate disclosure to investors of acquisitions that might lead to a change in control of the company. Section 13(d)(1) requires persons who acquire beneficial ownership of more than five percent of a class of equity securities in a company to notify the issuer, each exchange on which the security is traded, and the Commission of certain specified information. The acquiring shareholder has ten days after crossing the 5% threshhold within which to submit the required information, allowing the shareholder to acquire additional shares within that period prior to making any disclosure. In some situations, the ten-day filing period has enabled persons to acquire substantial positions prior to disclosure. The Commission has proposed legislation to reduce the ten-day filing period to two days.

2. Greenmail

"Greenmail" refers to an issuer's selective repurchase of a block of shares from a shareholder or group of shareholders, generally at a premium over the market price of the stock. "Greenmail" may be used by target company management to eliminate a threatened hostile takeover attempt or to remove dissident shareholders.

In 1984, the Commission proposed legislation that would have prohibited issuers from repurchasing their securities at a premium above their market price from persons who had held more than 3% of the class of securities for less than two years unless the issuer made a similar offer to all holders of the class of securities, or had prior shareholder approval. In January 1986 the Commission concluded that direct economic consequences to the paying corporation, market forces, state actions, shareholder litigation, changes in the tax laws and the adoption by many companies of by-laws that prohibit the payment of "greenmail," had significantly inhibited the payment of "greenmail."

The recent resurgence of this activity includes Goodyear Corporation's repurchase of shares from Sir James Goldsmith, CPC International's repurchase of shares from Ronald Perelman, and repurchases by USG Corporation, Ashland Oil and Potlatch Corp. of shares from the Belzberg family. As a consequence, the Commission is again reviewing "greenmail" with a view to the possibility of regulatory or legislative proposals.

3. Unconventional Tender Offers

Recent court decisions narrowly construing what constitutes an "unconventional tender offer" that must be made in compliance with the Williams Act 13/ have prompted the Commission to study issues raised by substantial share acquisitions outside of the tender offer process. In its July 31, 1986 concept release, the Commission sought comment on whether regulatory action was necessary to ensure that substantial purchases during the course of or immediately following the termination of a tender offer were made in compliance with the Williams Act. Such a requirement would prevent buyers from using the market forces created by a pre-existing tender offer to acquire control of a company. It would also respond to concerns that the present regulatory scheme may encourage bidders to put a company "in play" by making a tender offer, only to bypass the Williams Act by terminating the offer and buying from market professionals, and that issuers and their "white knights" can defeat tender offers by buying from market professionals during the tender offer while the original offeror is prohibited from making such purchases.

4. "Poison Pills" and Other Defensive Tactics

The Commission also is reviewing issues raised by extraordinary restructurings undertaken by target corporations to defeat or deter tender offers. These include the acquisition or disposition of significant corporate assets, and the issuance or redemption of securities with extraordinary rights, commonly referred to as "poison pills."

C. CTS Corp. Decision

The Supreme Court's recent decision in CTS Corp. v. Dynamics Corporation 14/ could inhibit hostile tender offers. In this case, the Supreme Court upheld the validity of the Indiana Control Share Acquisition statute. The Indiana statute provides that whenever any person acquires more than 20%, 33% or 50% of the outstanding shares of certain Indiana corporations, those shares lose all voting rights. Those voting rights may be restored by a majority vote of "disinterested" shareholders, including those who may have tendered into the offer. The Court held that the statute was neither pre-empted by the Williams Act nor an impermissible state regulation of interstate commerce. In a related matter, the Supreme Court vacated a lower court judgment

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13/ See supra, note 11.

14/ Nos. 86-71 and 86-97 (U.S. Apr. 21, 1987).

in Ohio v. Fleet Aerospace Corp. 15/ and remanded the case to the U.S. Court of Appeals for the Sixth Circuit for further consideration in light of CTS.

Similar statutes are likely to be enacted by other states. The Commission staff is evaluating the probable effects of such laws on its regulation of tender offers and considering whether changes in federal regulation will be needed.

V. Dual-Class Capitalization

The New York Stock Exchange ("NYSE") and the Pacific Stock Exchange ("PSE") have submitted proposed changes to their rules to permit the initial or continued listing of the securities of issuers having multiple classes of common stock with unequal voting rights. At present, the rules of the NYSE and the PSE prohibit the listing of any securities of a company that has issued common stock with disparate voting rights. The rules of the American Stock Exchange prohibit listing of non-voting stock and limit disparities in voting stock. By contrast, the National Association of Securities Dealers ("NASD") has no listing standards with respect to the voting rights of stock issued by companies admitted for quotation on its automated quotation system ("NASDAQ").

Public hearings were held on December 16 and 17, 1986 concerning the NYSE's proposal to permit listed companies to issue classes of common stock with different voting rights upon approval by a majority of their independent directors and public shareholders. The Market Regulation Division is analyzing the comments and alternatives.

In a March 13, 1987 letter to the Commission, the NASD has proposed the adoption of a uniform rule by each equity securities market that would prohibit the listing of securities with unequal voting rights. This uniform rule would be subject to limited exceptions for companies that have dual-class capital structures at the time of their initial public offerings or that otherwise take action that does not disproportionately reduce the voting rights of existing shareholders.

While the NASD has not filed an amendment to its rules for Commission consideration, the NASD, the NYSE, and the Amex are discussing the possibility of proposing a uniform rule with respect to shareholder voting rights in light of the NASD's suggestion.

15/ No. 85-344 (U.S. Apr. 27, 1987).

VI. Program Trading

By telescoping into minutes and hours transactions previously executed over days and weeks, computerized hedging and arbitrage have increased market volatility in dollars, but not in percentage changes of the averages. Stock index options and futures enable investors, underwriters and others to hedge market risks at a fraction of the prior costs. Computerized arbitrage brings the prices of options and futures into line with those of the underlying securities, which increases the efficiency and liquidity of the markets.

To dampen the volatility on quarterly settlement dates when options and futures expire, the Commission proposed that certain order imbalances be displayed on the ticker tape during the last half hour of trading. The results have been encouraging. The Commission also encouraged and endorsed the Chicago Mercantile Exchange's ("CME"), the NYSE's, and the Chicago Board Option Exchange's proposals to settle certain stock index futures and options at opening instead of closing prices, and the CME's proposal to increase its margin requirements. The Market Regulation Division is monitoring these efforts and considering others to dampen interim and settlement volatility.

On September 11 and 12, 1986, the Dow Jones Industrial Average dropped 120 points on record volume, one of the sharpest market declines in history. 16/ The Market Regulation Division, with the assistance of the staff of the Commodity Futures Trading Commission, has reviewed this index-related trading to determine whether the market decline lent credence to concerns over the effects of index-related trading. The staff examined the magnitude of index-related trading in relation to overall market activity, the types of trading strategies that were involved, and the impact of this activity on market prices and volume, as well as fundamental economic factors. The staff concluded that the magnitude of the September decline resulted from changes in investors' perceptions of fundamental economic conditions, rather than from artificial forces arising from index-related trading strategies. Nevertheless, index-related futures trading facilitated the rapid transmission of these changed investor perceptions to individual stock prices and may have condensed the time period in which the decline occurred.

16/ The Dow's 86 point drop on September 11 was the largest single-day price move in terms of absolute points on the Dow average, and the largest on a percentage basis (4.61) since 1962.

VII. Internationalization

The benefits of the increasing internationalization of securities markets are enormous. The challenges are also great and immediate.

Foreign securities have become important vehicles for U.S. investors, and raising capital abroad has become significant to U.S. companies. For example, U.S. issuers raised a record $43.7 billion through international bond issues in 1986. Foreign issuers borrowed $6.1 billion in the U.S. bond market during the same year. On the equity side, U.S. investors purchased and sold $101.2 billion in foreign stock in 1986 while foreign investors' activity in U.S. corporate equity securities reached $277.3 billion.

This accelerating internationalization of the securities markets is significantly changing the ways in which the securities markets function and presents opportunities as well as challenges to market participants and to regulators. The Commission has increased its efforts to facilitate the development of international markets in a manner consistent with the U.S. securities laws.

Currently, the Commission is completing a report on the internationalization of the securities markets requested by the House Committee on Energy and Commerce and the Senate Committee on Banking, Housing and Urban Affairs. The report will cover a wide range of topics, including the scope of internationalization, multinational registration and disclosure issues, the functioning and regulation of international secondary markets and market professionals, the participation of investment companies in international markets, and the enforcement of the U.S. securities laws in an era of internationalization. The Commission submitted its interim progress report in October 1986 and expects to submit the final study in June.

As part of the study, the Commission sponsored a Roundtable on February 17, 1987. The participants, who included experts on many different aspects of internationalization, generally believed that the Commission should not impose additional regulations but rather should facilitate appropriate market development, that international clearance and settlement remain a significant problem, and that development of mechanisms for information sharing and surveillance among regulators is needed. Roundtable participants also suggested liberalization of registration restrictions in the Securities Act of 1933 to allow sophisticated U.S.

investors to participate directly in unregistered foreign offerings. 18/

Over the last few years the Commission has taken action in these and other areas. For example, the Commission has approved the establishment of linkages between U.S. and foreign markets, including trading linkages between the Boston Stock Exchange and the Montreal Exchange; between the American and Toronto Stock Exchanges; and between the Toronto and the Midwest Stock Exchanges. The Commission has also temporarily approved a quotation-sharing program between the NASD and the International Stock Exchange (formerly the London Stock Exchange). To ameliorate the problems surrounding international clearance and settlement, the Commission's staff has issued no-action letters to foreign clearing agencies wishing to establish automated securities processing links with their U.S. counterparts. The Commission also is considering the facilitation of multinational securities offerings through adopting reciprocal prospectus requirements with certain other countries. 19/

The Commission has emphasized the need to enforce the federal securities laws in the context of increasingly international markets. To accomplish this, the Commission has required that linked foreign and domestic markets, acting as self-regulatory organizations, develop surveillance and information sharing agreements. In addition, the Commission has pursued bilateral and multilateral mechanisms for obtaining information to carry out its enforcement responsibilities. In particular, as noted above, the Commission has taken the initative in negotiating international agreements providing for cooperation and information sharing with Swiss, Japanese, Canadian and U.K. authorities. Others are contemplated.

18/ On the day following the Roundtable, the Division of Corporation Finance issued a no-action letter to College Retirement Equities Fund clarifying Securities Act Release No. 4708 (July 9, 1964) to make it clear that a U.S. fund could buy unregistered French securities issued in the "privatization" of formerly state-controlled French enterprises. In April 1987, the Division issued a no-action letter to the French government with respect to procedures used to accomplish French privatizations again stating its view that U.S. private offerings of the securities could be accomplished concurrently.

19/ See Securities Exchange Act Release No. 21958 (April 18, 1985), 50 Fed. Reg. 16302.

VIII. Bank Securities Activities

On July 23, 1986, the Commission testified before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations in support of the Treasury Department's recommendations to permit banks to underwrite municipal revenue bonds and mutual funds. The Commission also stated that banks should be required to conduct both new and existing securities activities (such as underwriting government and general obligation municipal securities) in separate corporate affiliates within holding company structures and that these separate corporate affiliates should be subject to SEC regulation.

On May 1, 1987, the Commission submitted to Congress a legislative proposal to subject bank brokerage activities to SEC regulation.

The Commission has also endorsed the legislative recommendations of the Bush Task Group to

- Subject public offerings of securities (but not deposit instruments) by banks and thrifts to the registration requirements of the Securities Act; and

- Transfer administration and enforcement of disclosure requirements under the Securities Exchange Act for such securities exclusively to the Commission.

Under the current system, the bank and thrift regulatory agencies have jurisdiction over disclosure requirements for securities issued to public investors by about 400 banks and 300 thrifts, while the Commission has jurisdiction over such requirements for securities issued by about 1,000 bank and thrift holding companies. This means that there may be differences in disclosures relating to banks depending on whether they are owned by holding companies. Each of the depository regulators has staff performing the functions handled by the Commision for the 11,000 other publicly-owned reporting companies.

The proposed legislation would consolidate within the Commission the financial disclosure requirements for all publicly-owned companies, as well as for all public offerings of securities. If adopted, it would ensure that investors will receive the same disclosure protections with respect to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned companies.

IX. Accounting and Auditing

The Commission has proposed for comment a rule that would require periodic peer review for accountants that certify financial statements filed with the Commission. Peer review is, in effect, an "auditor's audit" -- a regular, independent examination of accountants' quality control systems by other accountants engaged in public practice to assess whether audits are being conducted in accordance with generally accepted auditing standards.

The auditors of a large majority of public companies currently participate in the peer review program of the SEC Practice Section ("SECPS") of the American Institute of Certified Public Accountants ("AICPA") Division for CPA Firms. Recently, several organizations and individuals have suggested that membership in the SECPS or a similar organization requiring peer review should be mandatory for accountants whose reports are filed with the Commission. Those advocating mandatory peer review include the National Commission on Fraudulent Financial Reporting, the AICPA Council, and representatives of eight major accounting firms.

In view of these developments and the Commission's continued support of peer review as a means of providing added assurance that auditors are consistently complying with professional standards, the Commission recently proposed rules that would require accountants reporting on financial statements included in filings with the Commission to undergo a peer review at least once every three years. 20/ An accountant could obtain its peer review under the auspices of a private sector peer review organization meeting specified standards or, alternatively, could have its peer review conducted by the peer reviewer of its choice, with the review supervised directly by the Commission. The Commission's proposing release also requests comment on means other than mandatory peer review, including a disclosure requirement, by which the Commission could encourage the use of peer review to improve the quality of audits and adequately inform investors of whether accountants have been peer reviewed.

X. Investment Management Developments

The Investment Management regulation program minimizes the risk to investors of loss from fraud, self-dealing, misleading disclosure, and other abuses in the investment company and investment adviser segments of the financial services industry.

20/ Securities Act Release No. 6695 (April 3, 1987).

A. Mutual Fund Regulation

The Commission has proposed to standardize the computation of mutual fund performance data used in advertisements and sales literature. The proposals are intended to permit meaningful comparisons of fund performance claims and to help investors better understand those claims. The Division of Investment Management is conducting a review of Rule 12b-1, a rule adopted in 1980 that permits mutual funds to use their assets to pay distribution expenses. The review focuses on development of Rule 12b-1 plans and distribution practices and the need for additional disclosure from registrants that have such plans.

B. Investment Advisers

In the past several years, the number of investment advisers has grown significantly (4,200 registered advisers in 1981 compared to 11,000 as of December 1986). In light of this increase, the Division of Investment Management has increased the productivity of the adviser inspection program and is also evaluating existing regulation and considering possible regulatory alternatives. One approach is a self-regulatory organization for investment advisers. A "full scale" SRO could assume responsibility for establishing and administering proficiency standards, conducting routine inspections, and disciplining members. Alternatively, an SRO performing inspections only could keep the Commission abreast of industry growth without creating an additional regulatory structure, although Commission oversight would still be required. Upon the recommendation of the Investment Management Division, the Commission endorsed the NASD's proposed pilot inspection program for the investment advisers of its members and their affiliates, which account for 43% of registered investment advisers.

At Congress's request, the Commission is conducting a study of the financial planning industry to assess whether regulatory changes should be made. The study will analyze planner characteristics and compensation, customer demographics, registration and inspections, and instances of fraud and abuse. The primary focus of the study is on 100 special financial planner inspections conducted by the Commission with the participation of state securities regulators. The staff will also evaluate the NASD pilot program. The study should be completed by the end of 1987.

C. The Public Utility Holding Company Act

The Commission has proposed repeal of the Public Utility Holding Company Act of 1935, the principal purpose of which (the dismantlement of the multitiered public utility holding companies) was achieved over 20 years ago.

XI. Financial Guarantee Study

As part of the Government Securities Act of 1986, Congress directed the Commission to report on the use of the exemption in Section 3(a)(2) of the Securities Act for securities guaranteed by banks and the use of insurance policies to guarantee debt securities. The Commission issued a concept release 21/ and received numerous comments from insurance regulators, insurers, banks, rating agencies, and others. In addition, it held a public hearing on March 23, 1987 to hear testimony on the issues raised. Currently, the Commission's staff is preparing a report to Congress and is consulting with the federal banking agencies.

XII. Technical Amendments

In 1983, the Commission proposed the Securities Law Technical Amendments Act to make technical, clarifying, and conforming amendments to the securities laws. In 1985 the Commission submitted a revised version of the bill to Congress.

The Commission continues to endorse the enactment of the technical amendments and believes that the proposals are noncontroversial. The great majority eliminate typographical errors and obsolete and ineffective provisions.

* * *

Thank you for this opportunity to present this overview of the Commission's fiscal 1986 results, its 1988 - 1990 authorization request, and its ongoing efforts.

21/ Securities Act Release No. 6688 (Feb. 6, 1987).

Let me now excuse Chairman Shad and I'd like to call the witness from the GAO to the table and once the witness is seated and the room is quiet again, I'm going to have Mr. Harris, together with his counterpart on the other side, commence the questioning and then I will return as early as I am able to from this vote on the floor.

Mr. HARRIS. Mr. Anderson, thank you for appearing before us today. You and your staff have been extremely helpful to the subcommittee and we wish you would go ahead and proceed.

STATEMENT OF WILLIAM J. ANDERSON, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT PROGRAMS, GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY CRAIG SIMMONS AND JAMES T. CAMPBELL, GAO

Mr. ANDERSON. Thank you, Mr. Harris. I'd like to start by introducing the gentlemen at the table with me. To my right is Craig Simmons. Craig, in GAO's lingo, is an Associate Director in charge of an area we call Financial Institutions and Markets. Craig is concerned with all the work we do at the bank regulatory agencies, the thrifts. He's been involved in our insider trading work for Mr. Dingell, our Farm Credit System proposal for the fix over there and that sort of thing. So he has a broad area of responsibilities.

To my left is Jim Campbell. Jim is our group director and he's in charge of our work at SEC itself.

With your permission, I'd like to have my full statement entered in the record and I've summarized it here and it runs around 9½ minutes, if you can abide with that.

Mr. HARRIS. Your full statement will be included in the record.

Mr. ANDERSON. Thank you.

NEED FOR INCREASING SEC'S RESOURCES

We are here today to support the need for increasing SEC's resources. Unfortunately, we are in the embarrassing position of telling you the agency needs more, but unable to say exactly how much more. But certainly the increases requested for fiscal years 1988, 1989, and 1990 will still leave SEC short of what would be required to recapture the level of oversight and regulation achieved in the late 1970's. Let me provide some statistics on what's been happening since 1980. I blush to read them one more time, but they still are effective.

Shares traded, up 380 percent since 1980; number of broker-dealers, up 74 percent; number of investment companies, up 80 percent; number of 1933-34 act filings, up 42 percent; and over that same period of time SEC staff years went down 7 percent, it went down from 2,041 to 1,898 in 1986.

What are the consequences of the situation I just described? Well, in 1979, 91 percent of the 1933-34 act filings were reviewed. In 1986, 12 percent.

Second, since the early 1980's, the backlog of unreviewed 10(k)'s has nearly tripled, from about 5,000 to about 15,000.

Finally, cause examinations as a deliberate matter of policy, are down from 549 in 1979 to 69 in 1986.

Now I am purposely citing the bad things that have happened as a result of SEC's resource squeeze and we certainly recognize all the good things that SEC and Chairman Shad were able to point to this morning and agree that he's been very successful in doing an awful lot with a little.

But I don't think that our views here convey an incorrect picture of what has happened at SEC over the past 6 years.

The world SEC deals with has been getting increasingly complex. Futures, options, indexes, international trading, ever-increasing volumes combine to put the pressure on the agency and, like other agencies across Government, this one was not given the resources needed to fulfill its mission with excellence. I kind of think I see an analogy to what I saw at IRS, another agency that I'm responsible for, where I think it was 4 years ago GAO—I testified for the first time on the need to give an agency more resources rather than less, pointing out that as the incidence of audit was going down and more and more people were playing the audit lottery, that somebody ought to wake up and say you can't treat this agency like every other executive branch agency when you're making meat-axe budget cuts and personnel cuts.

I think the same sort of situation applies here to SEC. I kind of think that it has a special mission and stands apart somewhat—perhaps not to the extent of IRS but certainly somewhat. Let me now recap some of the major points that we make in our full statement.

First, we believe that SEC could do a better job of informing the Congress of the adequacy of its resources. This could be accomplished by describing what needs to be done in the way of oversight and regulation under each of its mission components so that Congress can assess where the agency stands at its current and projected resource levels.

For example, the Commission stated in its 1980 budget estimate—let me take you back 6 years—that as a long-term objective it needed to conduct 2,650 investigations and complete 1,600 enforcement actions annually to preserve the integrity of the securities market.

The budget observed that the 1980 resource request would allow the Commission to conduct about 1,675, instead of 2,650, investigations; and 850 instead of 1,600 enforcement actions.

The Commission then pointed out that the requested level of resource application would permit no progress toward achieving its long-range enforcement objective. In fact, some of the commentary in the 1980 budget request read: "It is felt that the projected 1980 personnel level will provide a barely acceptable level of protection to investors and deter potential wrongdoers."

The 1988 request does not identify long- and short-range objectives for the enforcement program and thus it is unclear how far the requested resources will take it toward achieving whatever those objectives might be.

I asked my staff to take those 2,650 investigations that were set forth in 1980 as the long-range objective for SEC and price it up. In other words, what would it take to get up to that level? Last year, for example, there were 1,100 investigations against that 2,650 target.

They tell me that they calculate crudely that it would take over 1,300 staff years rather than the 650 or so which are the total for the enforcement area if they were going to hit that 1980 target on the number of investigations.

Similarly, the 1980 budget request showed that the Commission's long-range objective for the full disclosure program included the review of all new 1933 act registration statements in 20 days or less and all 1934 act annual statements in 270 days or less. The budget went on to describe what percentage of these filings the Commission would actually review with approval of its 1980 resource request and what progress it would thus make in achieving the long-range objective.

Again, while the 1988 budget provides a good description of the program environment by emphasizing the growth in filings and the percentage of filings that will be reviewed, it does not show clearly what the Commission should be doing in the filings review area to accomplish any specific disclosure goal or objective. Stated simply, we believe the Commission's budget should provide the Congress better insight into what the Commission feels it needs to accomplish, how much it expects to accomplish with the resources requested, and what is left undone.

SEC DEPENDS ON THE SRO'S

Let me briefly touch on this shared oversight concept because in fact the SEC does depend on the SRO's heavily for support in market oversight.

We reported last September that oversight of the SRO's themselves has generally worked well in the past. However, we also pointed out that some Commission staff had misgivings about the SRO's capability to handle the added responsibilities. This is an area that deserves further study.

I concur in the statements I heard from up front here today that this is an area of potential concern as to exactly what the SRO's are putting into the way of fulfilling their oversight responsibilities. There are resources demands that I could see they might try to avoid as well as operating considerations that might tend to deter them from making an appropriate level of effort.

Mr. HARRIS. How can you help us get a handle on that?

Mr. ANDERSON. I'm trying to think through how the type of GAO assignment—we've already had discussions amongst ourselves. It would require the cooperation purely and simply of the SRO's. We don't have access authority there, Mr. Harris, as we do, for example, to SEC—its books, records and people.

We tried to work behind the SEC in what we've done so far and it's not really a satisfactory way of seeing what's going on out there. I think that perhaps we could consult with SEC and point the way how a GAO evaluation might be undertaken to really get a grip on what's being done and what needs to be done at the SRO's and I'd like to explore that with SEC and I know it's an area where we feel that more needs to be done.

Craig, do you want to comment?

Mr. SIMMONS. Well, I think just going into it, we could use a lot better information on the levels of staffing that the SRO's have

right now, how much they have increased, where they are going, what the training programs are, how much examiners are paid, what their education is, what turnover rates are. We have very little information on that and we need a lot more than that just going in to then begin to try to shape some kind of study that might enable us to get a better handle on how good a job the SRO's themselves are doing.

Mr. ANDERSON. There's a lot——

Mr. HARRIS. I didn't mean to interrupt you. I'd just like to say we would like to work with your staff in that area to get a better handle on that.

Mr. ANDERSON. Thank you. We appreciate that. I know one thing. I was greatly surprised to hear that there were 5 people in the section concerned with the SRO oversight per se at Commission headquarters. I understand that some of them left not long ago and it was understaffed even more for a while.

Now they do a lot in the way of the broker-deal examinations and that in fact is providing insight as to what kind of a job the SRO's are doing. We're just kind of suspect whether in fact it's enough.

Let me now highlight our observations on some of the specific items included in the 1988 budget request.

EDGAR

EDGAR, I know that in behalf of Chairman Dingell, GAO has been closely following and working with SEC in trying to ensure that EDGAR is brought onboard appropriately.

In fact, Chairman Shad, before he left, came over to me and thanked me for the assistance that we have been providing. I don't know about Chairman Dingell's assistance, but I'm sure he appreciates that as well, in pointing out some things that SEC can see need to be done to ensure that EDGAR is brought onboard properly and potential problems avoided.

Second, the full disclosure program, no evidence that SEC is doing anything to address the problem of its inability to review all corporate filings or to reduce the increasing backlog of 1934 act financial reports. There is a backlog problem there.

Now in their budget they talk about resource applications but they really don't get into the problem that currently exists, the things that aren't being done now.

The enforcement program, third, up 55 staff years and obviously warranted. Again, in the law enforcement area, the eternal question—how much is enough?

Certainly, the 55 are needed. As I think the insider trading work makes more and more demands on SEC's resources, something has got to give in terms of the other things that it's responsible for looking at.

I think that the number of cases could be misleading because some of these cases I'm sure in the insider trading area are making tremendous demands on their enforcement resources.

Fourth, market regulation, up 10 staff years, and it doesn't seem like enough. Those 10 staff years will be needed basically to handle the new responsibilities that they have under the Government Se-

curities Act where they are going to be responsible for providing some type of regulation over that 100-200—nobody really knows the group of presently unregulated Government securities dealers.

There's a need to rethink their overall strategy for overseeing SRO's and their member firms, to repeat what I said earlier, in the market regulation area.

Fifth, investment management regulations, up 13 staff years, seems justified in view of the large increase in investment companies and advisers in recent years.

It may not be enough if an SRO is not established. I thought that Chairman Shad made some good points there, but I thought he tended to downplay a bit perhaps the potential problems if an SRO is not created, and when I think of the frequency of examinations, for example, in the thrift institutions and bank area and the frequency of examination that they're able to provide with the resources currently applied to this, there's a big difference. And to the extent that the affairs of those concerns are volatile at all, the interval between examinations could come home to roost somewhere along the way.

I would like to conclude my remarks by summarizing the principal points of our testimony.

We find no reason to question the need for an increase in the Commission's resource level for 1988 and for future years. We cannot, however, affirm the appropriateness of the size of the increase or the exact allocation being proposed by the Commission.

We do observe, however, that the 1988 budget increase requested will not enable the Commission to handle its work load as it did in the 1970's. Whether the level of oversight and resources which the 1980 Commission believed was necessary can serve as appropriate criteria for assessing the adequacy of today's oversight and accompanying resource needs is a matter of judgment, unfortunately.

The Commission expressed concerns in its 1980 budget Commission about whether its requested staffing was adequate to provide reasonable assurance of accomplishment of its mission. It seems safe to assert that in view of the growth of market activities since 1980, the Commission's present resources and those proposed for 1988 would have been viewed as woefully inadequate by that earlier Commission.

Today's Commission believe that its selective approach to work load in many areas of its activities is enabling it to accomplish an adequate level of oversight. Whether the current approach is more successful, less successful, or just as successful as the approach to oversight taken in 1980 is unclear. There is simply not enough information in the Commission's recent budget submissions to reach a conclusion one way or the other.

We are concerned that when you have a selective review process that there are vulnerabilities associated with all the things that aren't being looked at and I haven't seen any evidence that those vulnerabilities have really been assessed or understood by the Commission or explained to the Congress in connection with the resources that are requested.

At present, neither we nor the Commission can determine precisely how much oversight is needed in order to provide reasonable

assurance that the markets are functioning in a fair, orderly, and efficient manner.

We believe that in order to answer the longer-term question of how much is enough better insight and oversight needs and the linking of those needs with work load objectives and requested resources will be required. We will continue to work with subcommittee staff, as we have in the past several months, to assess the adequacy of the Commission's resources and ultimately help it come up with a more informed basis for judging the adequacy of the Commission's resource levels.

I'll stop there, Mr. Harris, and we will try and answer any questions.

[The complete prepared statement of William J. Anderson follows:]

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Perspectives on the Securities and Exchange Commission's Budget

Statement of
William J. Anderson, Assistant Comptroller General
General Government Programs

Before the
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in your hearings on the Securities and Exchange Commission's FY 1988-90 authorization request and its related FY 1988 budget request.

The Commission has requested the second largest budget increase in its 53-year history. There has been enormous growth in recent years in the securities industry as well as mounting concerns over the efficiency and fairness of the financial markets. At the same time, the Commission's resource levels have remained relatively constant. As a result, we and many people in the industry and the state regulatory commissions believe the Commission should be provided more resources.

But the ultimate question is: How much is enough? That is, what level of federal presence is necessary to accomplish the regulatory objective of responsible oversight and what are the resources that the Commission needs to provide such oversight? We cannot answer that question today. And, as far as we can determine, neither can anyone else. However, our overall impression is that even the 27-percent dollar increase, part of which would fund a 7-percent increase in staffing, may be insufficient to adequately oversee today's markets.

My testimony is divided into two parts. In the first part I would like to share with you our views about what information is necessary to provide a better basis for answering the question of

how much is enough. In the second part of my statement I will offer our observations on the reasonableness of the areas of emphasis in the Commission's FY 1988 budget request in light of the varied and growing demands the agency faces.

DIFFICULTIES IN DETERMINING THE COMMISSION'S RESOURCE NEEDS AND MEASURING ITS ACCOMPLISHMENTS

Determining an appropriate resource level for the Commission is difficult, as is measuring precisely its accomplishments at given resource levels, because:

-- The budget documents themselves do not indicate what the Commission believes it should be doing to provide an effective level of oversight and, consequently, what its resource needs are.

-- The responsibility for effective oversight of the securities markets is shared jointly by the Commission and the industry itself. Any assessment of the Commission's needs must of necessity take into account the other resources that are applied to the oversight of markets. There are also differing perspectives on the balance of oversight responsibility that should exist between the federal government and the industry itself.

-- Measuring the Commission's program accomplishments is difficult because of the lack of data on how much violative activity exists in the market and the deterrent effect of the Commission's regulatory and enforcement efforts.

DETERMINING NEEDS

We found that, for the last several years, the Commission has not presented its long-term oversight goals and objectives for its major programs in its budget documents. Nor have these documents described the extent that the resources being requested will enable the Commission to achieve long-range goals and objectives.

In earlier years, the Commission did provide this kind of information as part of its budget presentations to the Congress. The FY 1980 budget request, for example, clearly stated the program goal, the long-range and FY 1980 objectives, and prior-year accomplishments for each major program. In addition, the budget estimate showed the impact of the resources being requested on the Commission's progress toward meeting its long-range objectives.

To illustrate, the Commission stated in its FY 1980 budget estimate that, as a long-term objective, it needed to conduct 2,650 investigations and complete 1,600 enforcement actions annually to preserve the integrity of the securities markets. The budget observed that the FY 1980 resource request would allow the Commission to conduct about 1,675 investigations and 850 enforcement actions. The Commission then pointed out that the requested level of resource application would permit no progress toward achieving its long-range enforcement objective.

The FY 1988 request does not identify long and short-range objectives for the enforcement program and thus it is unclear what the Commission believes it should accomplish and how far the requested resources will take it toward achieving whatever those objectives might be.

Similarly, the FY 1980 budget request showed that the Commission's long-range objective for the full disclosure program included the review of all new 1933 act registration statements in 20 days or less and all 1934 act annual reports in 270 days or less. The budget went on to describe what percentage of these filings the Commission could actually review with approval of its FY 1980 resource request and what progress it would thus make in achieving the long-range objective. Again, while the FY 1988

budget provides a good description of the program environment, by emphasizing the growth in filings and the percentage of filings that will be reviewed, it does not show clearly what the Commission should do in the filings review area to accomplish any specific disclosure goal or objective.

Stated simply, we believe the Commission's budgets should provide the Congress better insight into what the Commission feels it needs to accomplish, how much it expects to accomplish with the resources requested, and what is left undone.

SHARING OVERSIGHT RESPONSIBILITIES

It is a long established principle that the Commission shares the responsibility of assuring fair, orderly, and efficient capital markets with the industry's self-regulatory organizations (SROs). The Commission's mandate provides it with considerable leeway in deciding how strong a role it will play in overseeing markets. And, any decisions made in this regard have resource implications for the Commission.

There are two issues here. First, we are not certain about the level of market oversight the SRO's can effectively provide, given their own resource constraints and other inherent limitations. Second, we believe the Congress needs better information to gauge the appropriate level of direct federal

oversight that should be provided in order to better determine the Commission's resource needs.

The Commission has increasingly shifted responsibility for maintaining effective market oversight to the SROs. We reported last September that oversight of SROs has generally worked well in the past. However, at that time, we observed that some Commission staff had misgivings about the SROs' capability to handle the added responsibilities. We reported that the SEC has substantially reduced its number of "cause" examinations (those involving an indication of some broker/dealer wrongdoing that the Commission thinks is serious enough to warrant looking into) by transferring this review responsibility largely to the SROs. In FY 1980 the Commission conducted about 500 such reviews and in FY 1988 expects to do 60. Some Commission staff were not sure the SROs had sufficient, experienced staff to conduct thorough broker/dealer reviews on time, and to handle all investor complaints, and other matters. We are not certain what level of oversight responsibility the SROs can handle effectively. But this is a question that must be answered in order to adequately define SEC's resource needs.

The second issue--what level of direct Federal oversight is appropriate--is of equal importance in eventually determining the Commission's appropriate resource level. In 1975, the Congress amended the 1934 Exchange Act to give the Commission

additional authority over the SROs. But, as we reported last September, the Commission had rarely used its new powers, preferring instead to use a "give and take" approach resulting in negotiated solutions to deficiencies the Commission believes need correction.

Legitimate differences of opinion will always exist over the balance of oversight responsibility that should exist between the government and the industry. And the Congress' views on this matter have an important bearing on the Commission's resource needs.

MEASURING PROGRAM ACCOMPLISHMENTS

Finally, as with any law enforcement agency, the Commission faces a challenge measuring program accomplishments because there is no way of knowing how much violative conduct is occurring in the markets or the deterrent effects of oversight programs.

The insider trading problem illustrates this point. The Commission had increased its efforts to detect insider trading in the early 1980s. This increased vigilance was presumed to be having a deterrent effect on this kind of behavior. Then an anonymous tip led to the discovery of the current massive insider trading problem. Most observers were shocked and dismayed at the apparent magnitude of the problem and the fact that it had

existed over so many years. This example serves to illustrate the difficulty of assessing the significance of the deterrent effects of the Commission's oversight and enforcement activities.

I would like at this point to turn to the details of the Commission's FY 1988 budget submission.

ANALYSIS OF COMMISSION'S FY 1988 PROPOSED BUDGET

The Commission's FY 1988 budget estimate totals $145 million and 2,086 staff years, representing a $30.5 million (27 percent) funding increase and a 136 (7 percent) staff year increase over the FY 1987 approved budget. We have some concerns about both the amount of the increase as well as its allocation.

CONCERNS ABOUT THE REQUESTED LEVELS

The requested increase for FY 1988 is part of a longer term effort to increase the Commission's resources from their current level of about 1,900 staff years to about 2,750 staff years in 1990. The authorization request containing this increase is based on contemplated changes in the regulation of financial services industry participants, market developments believed likely to occur in the future, and initiatives the Commission believes need to be undertaken. It does not appear to recognize the concerns that have been expressed by others over the growing

disparity between the resources the Commission has devoted to oversight and indications of market expansion and complexity. We are currently working with your staff to further analyze the Commission's FY 1988 - 1990 authorization request.

During the 1980s the Commission has operated in an environment of growing markets and constrained resource levels resulting from budget austerity measures. Because of this, the Commission has had to alter its basic approach to regulation and oversight, becoming far more selective at what it does, assigning more work to the SROs, and attempting to automate many tasks previously performed manually.

The Commission has stated that because of its productivity enhancing initiatives, it has been able to keep pace with the growth in markets. However, we have questioned this view. Last August we reported that the numbers used by the Commission to demonstrate an increase in the productivity of its enforcement staff were not valid because the Commission's analysis treated all cases equally, regardless of their complexity. We are also currently analyzing the Division of Corporation Finance's selective review process to assess whether the targeting criteria used are identifying filings most in need of review.

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In light of these considerations, it is useful to look at where the Commission expects to spend the increased resources that it is requesting for FY 1988.

CONCERNS ABOUT THE ALLOCATION

The Commission is requesting a 43 staff year increase and $19 million in expenditures for its full disclosure program. Of the increase, $15 million is designated for the agency's transition to EDGAR in FY 1988, and the other $4 million is for maintenance of existing staff. This project is designed to provide for electronic receipt, processing, and dissemination of corporate filings. In an earlier report, we identified issues that the Commission needs to resolve before it awards the EDGAR operational system contract. The Commission has recently agreed to take additional steps to address each of our areas of concern. While these steps should resolve the issues discussed in our report, we believe that they need to be completed prior to contract award so that the Congress can have sufficient information in deciding whether development of the operational EDGAR system should be authorized and funded.

We believe the Commission can justify an increase in staff years for the full disclosure program on the basis of the growth in number and complexity of corporate filings and its need to

review some number of the filings to ensure proper financial disclosure. However, no increase is being requested specifically for the review of corporate filings, even though an increasing number of filings are unprocessed and thus receive no review. We reported last July that due to the increasing number and complexity of higher priority filings, there was a growing backlog of unprocessed 1934 Act annual financial reports. The Commission reviewed about 32 percent of these filings in FY 1983, and expects to review about 17 percent in FY 1988. While the Commission may review, but not count in its workload statistics, some of these reports in connection with its reviews of the companies' other filings, it does not plan to review and most likely will not review the vast majority of these filings.

The Commission plans to allocate an additional 55 staff years to the enforcement program in FY 1988. We believe the Commission can appropriately justify this allocation on the basis of substantial growth in market activity and the resulting possibilities of increased fraud. The Commission has stated that the incidence of securities law violations is proportional to the size and activity of the securities markets. The indicators of market growth such as the volume of trading, the broker/dealer population, and the number of securities industry employees all point to greater demands being placed upon this program.

The budget request also indicates an additional 10 staff years in FY 1988 for the market regulation program. The additional staff years will be used primarily to respond to new responsibilities, namely, the oversight of an anticipated 100-200 government securities broker/dealers as required in the 1986 amendments to the Exchange Act. No staff year increase is specifically provided in the FY 1988 budget to deal more comprehensively with the growth in the broker/dealer population from 6,730 in 1980 to 11,700 at the end of 1986. Although we do not know what increase is necessary for the Commission to effectively discharge its market oversight and regulation responsibilities, we believe the adequacy of the resources devoted to this area warrants further examination, particularly in light of concerns over the transfer of responsibility for broker/dealer oversight to the SROs that has been observed in recent years.

Finally, in the investment management regulation area, the Commission is asking for a 13 staff year increase. Again, we believe the Commission is justified in seeking this staff year increase on the basis of the significant increase in the number of investment companies and investment advisers, and the need to examine them with reasonable regularity. However, this increase may not be sufficient if the Commission is unsuccessful in adopting rules to exempt certain investment advisers from federal

registration or if an SRO is not established to handle some of the oversight responsibility.

CONCLUDING REMARKS

I would like to conclude my remarks by summarizing the principal points of my testimony.

We find no reason to question the need for an increase in the Commission's resource level for FY 1988 and for future years. We cannot, however, affirm the appropriateness of the size of the increase or the exact allocation being proposed by the Commission.

We do observe, however, that the FY 1988 budget increase requested will not enable the Commission to handle its workload as it did in the late 1970s. Whether the level of oversight and resources that the 1980 Commission believed was necessary can serve as appropriate criteria for assessing the adequacy of today's oversight and accompanying resource needs is a matter of judgment. The Commission expressed concerns in its FY 1988 budget submission about whether its requested staffing was adequate to provide reasonable assurance of accomplishment of its mission. It seems safe to assert that, in view of the growth in market activity since 1980, the Commission's present resources

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and those proposed for FY 1988 would have been viewed as woefully inadequate by that earlier Commission.

Today's Commission believes that its selective approach to workload in many areas of its activities is enabling it to accomplish an adequate level of oversight. Whether the current approach is more successful, less successful or just as successful as the approach to oversight taken in 1988 is unclear. There is simply not enough information in the Commission's recent budget submissions to reach a conclusion one way or the other.

At present, neither we nor the Commission can determine precisely how much Commission oversight is needed in order to provide reasonable assurance that the markets are functioning in a fair, orderly, and efficient manner. We believe that in order to answer the longer term question of how much is enough, better insight on oversight needs and a linking of these needs with workload objectives and requested resources will be required.

We will continue to work with Subcommittee staff, as we have in the past several months, to assess the adequacy of the Commission's resources and, ultimately, provide the Subcommittee with a more informed basis for deciding "How much is enough."

That concludes my prepared statement. We would be happy to respond to any questions at this time.

Mr. HARRIS. Mr. Anderson, thank you very much for your excellent testimony.

Mr. Lykos has one quick question and then I will go through a line of questioning with you.

Mr. LYKOS. Essentially, we can argue about how much is enough or not. I think that essential question that you have not addressed to my satisfaction is: Has the SEC done a sufficient job with its current resources? I think that is the nature of the inquiry that we should really try to address right now.

Additionally, I don't know if you're familiar with the SEC's annual report or not, but it contains some statistics which show an increase in activity over the last 6 years and I was wondering whether you have any quarrel with the accuracy of those figures.

Are these figures accurate and has the SEC done an adequate job or more than adequate job with the resources that they presently have?

Mr. ANDERSON. Let me say that I subscribe totally—as far as I know, they are accurate and I subscribe to that one exhibit that Commissioner Shad used up front where he demonstrated the increase in any number of actions and accomplishments on the part of the Commission.

I think the Commission and Chairman Shad can take credit for significantly improving what they are doing with the resources that they have. I agree totally with that in terms of I think that there are real accomplishments and I still believe that a fundamental issue is, what would they have done with even—you know, in my opinion—a more appropriate or at least a higher level of resources? What they were able to do with what they had, it's commendable, but I think there are still things that are left undone that in their earlier, less hectic years of their existence they were able to get done.

So I would still submit that despite the fact that they are entitled to much credit that they still could be doing more and more needs to be done.

Mr. LYKOS. I don't think you will get any quarrel from us that, potentially any agency can always do more, but we are more properly concerned that the SEC is doing enough with the funds authorized by this committee.

Steve, I'd like for these statistics to be put in the record.

Mr. HARRIS. They will be put in the record. (see p. 140.)

Mr. Anderson, you indicated in your statement that the General Accounting Office does not know what resources are needed to provide an effective level of oversight of the securities industry.

COMMISSION'S BUDGET REQUEST MAY BE INSUFFICIENT

Why do you believe, then, that the Commission's fiscal year 1988 request may be insufficient?

Mr. ANDERSON. I would base it primarily on the list of things that I said that aren't being done. For example, the fact that we have an increasing backlog of unreviewed 10(k)'s, the fact that the frequency of investment company and investment advisers inspections is so low. I would say that I have to accept that the considerably higher investigative and regulatory objectives that were set

forth by the Commission earlier that are being achieved less than 50 percent today in terms of number of investigations, in terms of number of enforcement actions, lead me to believe with a fair degree of assurance that they are still short.

Mr. HARRIS. Your statement compares certain aspects of the Commission's fiscal year 1980 budget with its fiscal year 1988 budget and points out how they differ.

Do you believe the Commission was doing a better job of budgeting in fiscal year 1980?

Mr. ANDERSON. I don't have any reason to believe that they were doing a better job of budgeting in fiscal year 1980. My sense is that they came closer to having the budgeted funds that they needed in 1980 than they do today, that in fact in recent years they have been working from a mark that was given to them and they had to find a way to cope with it. In fact, it meant giving up some things that needed to be done and would have been done with the same level of budgeting that they had back in 1980.

Mr. HARRIS. A key issue in setting the fiscal year 1988 budget level for the Commission involves the question of how well the industry is policing itself. You indicated some Commission staff have expressed concern over this shift.

What is the nature of these concerns?

Mr. ANDERSON. Perhaps the most significant place I heard them was in connection of where these for-cause issues are being farmed out to the SRO's rather than being investigated firsthand by SEC personnel. I cited in my testimony that whereas in 1980 something like 550 for-cause examinations were conducted by the Commission, they are down to around 60 this year. I know that Commission personnel have expressed to us whether in fact those for-cause actions are going to be appropriately investigated, given the level of resources that are available to the SRO's.

I have heard concern expressed about the qualifications and the numbers of resources that are available at some of the SRO's to pursue these matters—a tremendous turnover problem; like the Federal Government, that problem of inadequate salaries is not restricted to the Federal Government. We understand that that is a major contributor to some of the SRO's inability to hang on to good people that they are relying on for member firm oversight.

Mr. HARRIS. You mentioned on page 5 of your written statement that there are inherent limitations in the SRO's oversight of the markets.

What are some of these limitations?

Mr. ANDERSON. I would say that the very fact that self-regulation itself means that you don't have somebody totally independent and objective coming in from the outside. I think that has to color things somewhat. I don't think it damages them absolutely unacceptably, but on the other hand, it is a fact of life.

It is a fact of life that the SRO's in a sense are competing with one another and I'm really not sure what effect that might have.

It's not an arm's length transaction such as exists between the SEC and the broker-dealers that it goes out and investigates.

Mr. HARRIS. We discussed this a moment before, but have you been able to obtain from the Commission or the SRO's information to indicate whether the SRO's have increased their staffing to

handle the additional work that the Commission has shifted to them and the growth and the size and the complexity of the markets has generated for them?

Mr. ANDERSON. I think we were disappointed and surprised to find that SEC did not have good information on what was going on at the SRO's in terms of level of resources, organization and that sort of thing.

It is a fact that SEC inspections have succeeded in recent years in pointing up areas of needed beefing up at some of the SRO's. Surprisingly so. I remember reading one SEC document that took pride in a 1983 inspection that resulted at some unnamed exchange virtually doubling the staff that it was putting into oversight as a result of a member firm failure, and I'm telling myself, 50 years after the creation of this mechanism and here we are with a place that's been going on year after year woefully short of the resources that it needed to do a proper job. Something doesn't seem right.

BACKLOG OF UNPROCESSED FINANCIAL REPORTS

Mr. HARRIS. You state that there is a growing backlog of unprocessed 1934 act annual financial reports. Is the Commission keeping pace with the 1933 act registration statements and other filings, in your opinion?

Mr. ANDERSON. They are showing discrimination in that the most time-urgent things in fact are being appropriately handled. Under their selective review processes, they seem to be dealing with the most time-sensitive and otherwise sensitive matters in a fairly good fashion.

Craig, do you want to comment or Jim?

Mr. CAMPBELL. I'll just mention that we have a review, as you may know, underway to determine how the selections are being made—the bases or criteria being used—to select the filings. Of course, that is the basic approach the Commission is following in covering what it believes to be the filings that really need to be looked at.

Now we don't know how they make those decisions, but we have a review underway to find out.

Mr. ANDERSON. Which means I would expect in a couple of months we're going to have a better picture of whether the undone things represent significant things.

Mr. HARRIS. We'll look forward to getting that information from you.

Could you tell me about the nature of your review of the Division of Corporate Finances filing review process?

Mr. ANDERSON. Let me again turn to Craig and let him answer.

Mr. SIMMONS. I think I'll let Jim explain.

Mr. CAMPBELL. Well, there are basically three objectives in that review. One is first to find out just what is being reviewed and what isn't. There are many types of filings. SEC gives different levels of attention to the different types of filings. They range from just a very cursory look to a full-scale review.

The second objective is to determine what criteria are being followed in selecting the filings that the Commission considers to be in most need of review.

Third, we're looking at just an overall management of the program to determine if there may be better ways of selecting, reviewing, and reporting on the reviews that are made.

Mr. HARRIS. You have performed a significant amount of work at the Commission over the last several years, but you have not conducted, to the best of my knowledge, an audit of the Division of Investment Management Regulation.

Do you intend to review that division's functions any time in the near future.

Mr. ANDERSON. Yes, we certainly do. It's just been a question of coming up with the resources ourselves to do it.

Mr. HARRIS. When might we expect a report on that?

Mr. ANDERSON. The report could be as much as a year away.

Mr. SIMMONS. We won't begin the review until sometime this summer and the review will probably take at least 12 months to conduct. So it would be the summer after next probably at the earliest.

Mr. HARRIS. We look forward to that review as well.

Is it unusual for a Federal agency not to provide in its authorization budget request the identification of long-range goals and objectives, and do you think we ought to request this information from the SEC in the future?

Mr. ANDERSON. I can't speak with total authority on what's in most agencies' budget, Mr. Harris.

I think the important thing is, though, that if not in the budget, the numbers that are showing up in the budget ought to be the product of some type of a long-range process so that in fact you have that chart and road map of where you are going. And if asked, the agency, the questions that weren't asked today in terms of some of these areas, where do you want to be a few years from now should be answerable by the agency.

I would say that, given the SEC and the special concerns that have been voiced in a number of quarters about the adequacy of its resources, it might have been appropriate for them to give a clearer picture of where they stand with respect to where they ought to be.

Mr. HARRIS. What staffing level do you believe is appropriate for the SRO's to enable them to effectively oversee the industry? Is there any way at all of getting a handle on that?

Mr. ANDERSON. Not short of doing the study that we spoke about earlier either to be conducted by the SEC and some firmer standards and understanding of what is being done and what needs to be done.

Mr. HARRIS. Have you approached the SEC about such a study?

Mr. ANDERSON. No, we haven't. But as I said, I think it's become increasingly apparent to us, even in connection with preparing this testimony, that that's something that needs to be done.

I should mention that in the work we are doing on insider trading we are getting out to some of the SRO's and getting a sense of what their surveillance systems are all about and what investigative capacity they have.

You heard the Chairman speak of seemingly insufficient discrimination on the part of the SRO's as to what they send forward over to SEC. I don't know what that means really. I don't know whether

it means that they need more investigative capacity but lack the legal authority thereof to use out at the SRO's. I'm not comfortable about the way that we structure our present attack on insider trading.

INSTANCES OF SUSPICIOUS TRADING PATTERNS

I am still concerned, for example, that we had many instances that were flagged of suspicious trading patterns by some of the principals that are currently involved in this scandal and yet nothing was ever—we were unable to establish that cause-effect relationship, despite several years of knowing, for example, that Mr. Boesky had been flagged any number of times by the New York Exchange's surveillance system. I don't really understand what that means, but I suspect that part of it reflects on the adequacy of what's being done at the SRO's and maybe it's not fixable. I'll hold that out as a possibility, too, with the police powers and the investigative capacity that they have or could muster.

Mr. HARRIS. Do you believe that the Commission's resource constraints have created a morale problem among its staff? Is there any indication of that in terms of any of your reviews?

Mr. ANDERSON. A couple of years ago I know a bunch of young attorneys over there got their names—created quite a bit of press around town with some complaints they were voicing about an extremely heavy work load, poor working conditions, and things like that. I am not aware of the current status. I'll turn to the gentlemen on either side of me here to speak further on that.

Mr. SIMMONS. We became aware of it, in addition to the public meetings, we also became aware of it because Congressman Dingell asked us to look into it.

The Commission looked into it. I believe that they sent a questionnaire around to the staff.

Most of the complaints seemed to be without merit. However, morale and training did seem to be legitimate complaints. There was a lot of concern on the part of the staff. I believe that the training needs are being addressed by the Commission. I don't know what the Commission is doing in terms of the morale needs.

The main thing that the staff indicated was affecting morale was heavy work load and the fact that they were working in cramped quarters. We see the heavy work load in the numbers that we looked at and certainly if the Securities and Exchange Commission is going to get more resources they are going to become even more cramped in the future in the building that they are in now.

Mr. HARRIS. My final question is, is there any indication that the increased emphasis on insider trading has been done at the expense of other enforcement actions?

Mr. ANDERSON. I can't put numbers before you because the SEC is presenting their figures in terms of cases and I think cases are misleading in terms of just gauging the relative amount of resources going to insider trading as to going to their other enforcement activities.

I would say that given the number of cases, the intensity of investigation that these type of cases require, that I would feel really comfortable in saying that the increase in insider trading investiga-

tions has been at the expense of some of the other things that otherwise would have been done.

Mr. HARRIS. Thank you. Mr. Lykos.

Mr. LYKOS. Thank you, Steve. In response to the previous line of questions and answers that I was at the SEC in the Enforcement Division and I think that I can accurately compare the work load and the cramped quarters there with those in the Senate. They are pretty much the same over here as they are over there and at other agencies in the Government.

Cramped quarters and excessive work load aside, what do you think were the causes of the morale problem?

Mr. ANDERSON. That's all the information I have.

Mr. LYKOS. You mentioned something about the review of SEC registrations. Did you uncover any complaints by the SEC registrants about the timeliness of the SEC's processing of filings?

Mr. ANDERSON. As far as we know, the timeliness is not an issue. In fact, the turnaround is there. Now frequently turnaround is achieved by really not fulfilling the reviews. But still, I'm not aware of any complaints at all about timeliness.

COMMISSION HAS FAILED TO ARTICULATE LONG-TERM BUDGET PLANS

Mr. LYKOS. Earlier in your testimony you mentioned that the Commission has failed to articulate any long-term plans in the budget sent to this committee.

Did you discuss this with the Commission at the time you were conducting your review, or have you since discussed this point with anyone at the Commission? If so, how did they respond to your observations?

Mr. ANDERSON. I was not present at the meeting where this was discussed with them. I'll have to turn to one of these gentlemen here to help me.

Mr. CAMPBELL. Your question has to do with our point on the absence of longer-term objectives and so forth in the budget or in the documents that we reviewed?

Mr. LYKOS. Yes.

Mr. CAMPBELL. We did discuss our point with the executive director. He basically felt at that time they were following—in the 1980 era, the Commission was following a different approach to budgeting and that that was no longer required and he felt, I gather, no longer necessary.

Our view simply is that the Congress, and particularly this subcommittee, needs to have that kind of information somewhere and to be able to respond to questions such as Senator Riegle was asking this morning about what's going to be needed in the future.

And we are not convinced that that's been completely thought through at the Commission, or if it has, it hasn't been fully documented—at least not in the documents we've been able to see.

We did ask if there were documents other than the authorization request or the budget document, and we found that there were no such documents to lay out in any comprehensive way what is being done, what needs to be done, and how the resources will come to bear on what needs to be done.

Mr. ANDERSON. I think this is another issue, Mr. Lykos, that we expect to pursue further. In other words, we are not going to let it drop here. I would hope that we could persuade the Commission that it would serve their own purposes eventually to start thinking more in these terms of where they want to be down the road with respect to the type of coverage.

Mr. LYKOS. Just to clarify your response, are you stating that they resisted your suggestion?

Mr. ANDERSON. No, what they basically said was, "Oh, back in those days everybody acted like we were never going to run out of money," if you really want to know what the bottom line of what they had to say was. They said, "We're taking a more realistic view of what we can afford to spend in the scheme of what's going on across Government, the deficit, et cetera."

HOW MUCH COMMISSION OVERSIGHT IS NEEDED?

Mr. LYKOS. Just one other question. I am curious about the next to last paragraph in your testimony which states:

> At present, neither we nor the Commission can determine precisely how much Commission oversight is needed in order to provide reasonable assurance that the markets are functioning in a fair, orderly, and efficient manner.

Specifically, how do you propose that such a determination can ever be made and what factors would you suggest the SEC consider?

Mr. ANDERSON. It depends totally, as I view it personally—and I'm going to turn to the gentlemen here for support—it starts off with a real in-depth understanding of what the SRO's are doing and the adequacy of that. And then your own level of oversight is driven basically under the scheme that's in place by what you find out there.

I think that we have seen enough evidence of uncertainties and inadequacies on the part of what the SRO's are doing in this area that there's a need to step back and decide who is going to do what—well, No. 1, what needs to be done and who's going to do what? That's really what we have in mind, Mr. Lykos.

Mr. LYKOS. Are you saying that the SEC does an adequate job of providing oversight where the SRO's leave off but it is hard to determine where the SRO's leave off, or are you saying that the SEC does not do an adequate job of oversight because they cannot determine where the SRO's leave off?

Mr. ANDERSON. I don't think that they have really sat back and asked themselves that second question. That's the basic problem.

Gentlemen, do you want to comment on that?

Mr. SIMMONS. Well, I think just briefly, the level of oversight that one believes is needed is a matter of judgment. There are different regulatory philosophies. We have seen a swinging of the pendulum in terms of regulatory philosophy, regulation of financial institutions and securities markets over the years. It kind of swings back and forth.

And one's view in this area of what it is appropriate for the market to do and what it is appropriate for the Federal Government to do will define the oversight needs of whoever happens to be doing the regulating at the time.

I think the problem we have with the Commission's budget submissions in recent years is we can't determine what they think they need to do, wherein the earlier budgets there was at least an explicit statement of what they thought they could do, what kind of oversight they thought was needed, what that implied for work load down the road, what that implied for work load immediately, and what that implied for the resources that would be required to do that.

We don't see that in the Commission's budget submission this time. We haven't been able to find any evidence of that kind of thinking in the Commission—or if there has been, it certainly hasn't been committed to writing as a policy statement or that sort of thing, and I think that going in, recognizing the fact that differences of opinion will exist, you still need to know what any sitting Commission thinks it needs to do. And if the answer is, all we need to do is what we're doing, then I guess I find that rather unsatisfying.

Mr. LYKOS. No further questions.

Mr. HARRIS. Mr. Anderson, thank you very much. I apologize that the Senate schedule doesn't permit the Senators to be here. Once again, I want to commend you and your staff and Mr. Hobbs for being of tremendous assistance to the subcommittee and we look forward to working with you in the future on these issues.

Mr. ANDERSON. Thank you, Mr. Harris. We appreciate it.

Mr. HARRIS. Mr. O'Brien, to the extent we've been filibustering the clock here for a little bit, obviously, if the Senators weren't totally preoccupied on the floor you'd better believe that there would be a number of people here to hear your testimony and to ask you questions. But I wish you would go ahead and proceed.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. O'BRIEN. Thank you. I am Edward I. O'Brien, president of the Securities Industry Association, the trade association representing over 500 securities firms headquartered throughout the United States and Canada doing business on both a domestic and an international basis.

At the outset, we are pleased to have been asked to give our views in the subcommittee's review of the proposed SEC budget. We would like to have our written statement incorporated in the record and we will not take too much of your time in order to expedite things.

Mr. HARRIS. It will be.

VIEWS SUPPORTING PROPOSED 27-PERCENT INCREASE

Mr. O'BRIEN. What SIA can offer this subcommittee are our general views supporting the proposed 27-percent increase over last year's appropriation in the SEC's budget. Our reasons for these views rest on the growth in both the domestic and international securities markets. Almost 2 months ago, in fact, SIA's Trading Practice Committee recommended that the SEC's budget be increased for staffing, automation, and improvements in the enforcement of the Federal securities laws.

At first blush, a 27-percent increase in appropriations for the SEC on an annual basis may appear to be a large, and perhaps by some, an unjustified jump. However, put in the context of the past years' relatively small increases in the SEC's budgets and the explosion of growth in the securities industry and capital markets, SIA finds the request a perfectly reasonable one.

While not every market or every product falls under the jurisdiction of the SEC, some figures provide benchmarks for the dynamics of today's securities industry and they show the contrast between the 33-percent growth in the SEC's budget from 1981 to 1986 and the market growth for the same time period

Now in our written statement we have set forth many of those statistics and I would prefer not to repeat them at this time but to move on with the statement. Those figures do show, however, that the securities industry has enjoyed significant growth in that same 1981–86 period with some shifting of emphasis in lines of business down through those years.

While the figures clearly demonstrate the need for a larger SEC budget, we think it would be unwise and counterproductive to attempt to make the increase in the SEC's budget exactly commensurate with the percentages of growth in the various industry components. As SEC Chairman John Shad reported to an appropriations subcommittee on April 8 of 1987, over the past 5 years, through automation, paperwork reduction, and other staff and Commission initiatives, the resulting increase in the SEC's productivity has compared favorably with the growth in the marketplace.

Record results have been achieved by all SEC divisions. For example, since 1981, enforcement actions have increased 63 percent, SEC oversight examinations of broker-dealers have increased 73 percent, and of registered investment companies and investment advisers 155 percent. Further, in the past 5 years, the SEC reviewed 71 percent more full disclosure filings, which in themselves increased 35 percent.

These increases underscore the SEC's effectiveness in using its resources in hand and increasing its efficiency and productivity. We very much commend the SEC for this efficiency. We would hope that this trend toward greater efficiency will continue, especially in light of the proposed budget's allotment of an additional $20 million in fiscal year 1988, to cover start-up costs of the SEC's operational electronic disclosure system, the EDGAR system, and nine additional EDGAR staff positions.

SIA supports an increase in the budget for the Division of Corporate Finance so that, among other things, the SEC has the resources to develop a workable data processing system. The SEC has rightly placed a greater emphasis on the gathering of corporate information as fast as possible. In discussing trading abuses, the SIA's Trading Practices Committee's report—the one I referred to earlier—about 2 months ago stated the committee's belief—in fact, its strong conviction—that the sooner corporate information can be filed and made public, the less opportunity there is for misuse of such information, especially for illegal insider trading.

While we are certainly not management consultants, large budget increases, like large increases in the volume of securities markets, have to be digested. Excessive increases in staff members

in any organization in a short period of time can be counterproductive. In order for new staff members to be trained sufficiently and for existing management to integrate the new staff, as well as their responsibilities, into the existing organizational structure, the size of organizations must be increased incrementally over a period of time.

We believe that a higher level of supervision is appropriate across the board—at the industry level, at the SRO level, at the State level, and, of course, at the SEC. In fact, this is already in place and it will continue.

What is needed is a sensitivity by all of the need to meet the changes in the industry which are beyond dispute—those changes going on—so that there will be a balance between protection for the public and I might add a proper level of supervision. We are absolutely committed to that.

In conclusion, SIA feel strongly and supports the self- regulatory process. We support a strong SEC and we think that's indispensable to that self-regulatory process. We support the 27-percent increase in the budget for fiscal year 1988, so that the SEC can keep up with the increased size and complexity of the securities markets. A steady rise in the globalization of the world's securities markets necessitates that the SEC respond by examining and proposing changes in the Federal securities laws to accommodate market changes brought about by this very globalization.

Finally, if the SEC succeeds in its efforts to regulate the activities of securities subsidiaries of banks, as it has not proposed legislatively, it will need the extra resources from the proposed budget.

Thank you, Mr. Harris, and if there are questions I would be glad to answer them.

[The complete prepared statement of Edward I. O'Brien follows:]

Statement of the
Securities Industry Association
before the
Subcommittee on Securities
of the
Senate Committee on Banking, Housing & Urban Affairs
May 13, 1987

I am Edward I. O'Brien, President of the Securities Industry Association, the trade association representing over 500 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types--investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges.

SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

SIA welcomes the opportunity to appear before this subcommittee during its review of the proposed budget of the Securities and Exchange Commission for fiscal 1988. We are pleased to have been asked to assist in this subcommittee's review of the proposed budget. It must be stated at the outset, however, that although SIA has had a great deal of experience working with the SEC in its rulemaking capacity, we

do not have sufficient insight into the SEC's internal workings to be able to make a department-by-department analysis of the SEC's budget. We also find ourselves in the somewhat uncomfortable and anomalous position of being the primary spokesgroup of a regulated industry - the securities industry - and commenting on the budget of the industry's regulator.

What SIA can offer this subcommittee are our general views supporting the proposed 27% increase over last year's appropriation in the SEC's budget. Our reasons for these views rest on the growth in both the domestic and international securities markets.

Almost two months ago, in fact, SIA's Trading Practices Committee recommended that the SEC's budget be increased for staffing, automation, and improvements in enforcement of the federal securities laws. That Committee was formed earlier this year at the request of SIA's Chairman, John W. Bachmann, managing partner of Edward D. Jones & Co. in St. Louis, to study and make recommendations to SIA's Board of Directors in the areas of insider trading and mergers and acquisitions. The Committee issued its recommendations on March 24, 1987, in a report entitled, "Report By the Trading Practices Committee to the Chairman of the SIA."

At first blush, a 27% increase in appropriations for the SEC on an annual basis may appear a large, unjustified jump. However, put in the context of past years' relatively small

increases in the SEC's budgets and the explosion of growth in the securities industry and capital markets, SIA finds the request a reasonable one. In fact, measured in terms of growth in, among other things, the size of markets, new products, and firms regulated, the SEC's budget, even though showing a 33% increase from 1981 to 1986, has not kept up with the expansion of the securities industry.

While not every market or every product falls under the jurisdiction of the SEC, the following figures provide benchmarks as to the dynamics of today's securities industry and show the contrast between the 33% growth in the SEC's budget from 1981 to 1986 (and the 43% growth for the period from 1981 to 1987) and market growth for the same time period.

From 1981 to 1986, the SEC saw a 35% increase in disclosure filings by issuers, a 57% increase in the number of registered broker-dealers and a 86% increase in the number of registered investment companies and investment advisers. During that same period, the number of shares traded on the New York Stock Exchange increased by about 200% and volume on regional exchanges rose by almost 300%.

Not only has the traditional marketplace enjoyed tremendous growth in the last five years, but derivative products, such as futures and options, have come into their own. For example, some 98.5 million futures contracts were traded in 1981, compared with 184.4 million contracts in 1986.

Although not true for every year in the period, 1981-86 saw several records set for new issues and initial public offerings. In terms of initial public offerings, 1981 was a record year, with 355 companies raising $3.2 billion in new capital. The 1981 statistics pale in comparison to the 686 companies coming to market in 1983 for a total sharevalue of $12.4 billion. However, 1986 represents the highlight of the period as 717 companies raised $22.4 billion in new funds. In other words, the number of companies coming to market in 1986 was more than double the total coming to market in 1981 and more than seven times the amount of funds were raised.

The IPO market's clip was matched by the total primary market. While the number of offerings was over the 2,000 mark in most years during the period, 1986 stands as a record breaker. Over 3,700 issues of bonds, preferred stock and common stock were offered, amounting to a dramatic $285.3 billion in capital raised.

The securities industry itself has grown in unison with the growth of the securities markets. Measured in terms of capital for NYSE member firms, the industry's capital base has grown from $8.1 billion in 1981 to $29.8 billion in capital by year-end 1986. While the number of NYSE member firms waxed and waned over the 1981-86 period, ranging between a low of 599 in 1985 to a high of 639 in 1983, the number of registered sales people and branch offices escalated sharply. In 1981, NYSE member firms doing a public business employed 53,599 full-time

registered representatives; by 1985, the registered sales force had reached 75,011. The number of sales offices jumped 27% from 4,829 in 1981 to 6,144 in 1985. Moreover, the number of NASD member firms has virtually doubled, from 3,265 in 1981 to 6,658 in 1986.

As for industry revenue, NYSE member firms, as an example, garnered gross revenues of $19.8 billion in 1981; revenues increased 153% to $50.1 billion in 1986. While 1986 marks an exceptional year, even focusing on the 1981-85 period shows a 95% increase in industry revenues. Much of the growth the industry has enjoyed has come from nontraditional revenue sources, as intensifying competition both within and from outside the industry has caused many firms to diversify their revenue streams. Along the "bread and butter" revenue lines, commissions and gains on firms' trading accounts have more or less kept in step with industry growth, with revenues increasing 140% in the 1981-86 period. Profits from underwriting skyrocketed some 278%.

However, a look at the nontraditional revenue sources underscores the diversification of the industry. For example, mutual funds sales revenues or commissions have exploded, from $123 million in 1981 to $2.8 billion in 1986. Also increasing firms' bottom lines are money management fees, with revenues rising from $278 million in 1981 to $1.5 billion in 1986. The catch-all revenue category, which includes other securities-related revenues, shows, among other things, that

fees from mergers and acquisitions, private placements and repurchase transactions totalled $9.6 billion in 1986, over three times the $3.0 billion 1981 figure.

These figures show that the securities industry has enjoyed significant growth in the 1981-86 period, with some shifting of emphasis in lines of business. The growth of the industry has clearly outpaced the funds appropriated for the SEC in these years.

While the above figures clearly demonstrate the need for a larger SEC budget, we think it would be unwise and counter-productive to attempt to make the increase in the SEC's budget exactly commensurate to the percentages of growth in various industry components. As SEC Chairman John Shad reported to an appropriations Subcommittee on April 8, 1987, over the past five years, through automation, paperwork reduction and other staff and Commission initiatives, the resulting increase in the SEC's productivity has compared favorably with the growth in the marketplace.

Record results or the highest levels in years have been achieved by all SEC Divisions. For example, since 1981, enforcement actions have increased 63%, SEC oversight examinations of broker-dealers increased 73% and of registered investment companies and investment advisers increased 155%. Further, in the past five years, the SEC reviewed 71% more full disclosure filings, which themselves increased 35%

These increases underscore the SEC's effectiveness in using its resources in hand and increasing its efficiency and productivity. This also speaks well of the SEC management, and certainly is supportive of their reasonable request to increase their budget by 27%.

We would hope that this trend toward greater efficiency will continue, especially in light of the proposed budget's allotment of an additional $20 million in fiscal 1988 to cover start-up costs of the SEC's operational electronic disclosure system ("Edgar") and nine additional Edgar staff positions. As Chairman Shad stated in his April 8th testimony, the expansion of electronic filing of corporate documents with the SEC will improve the breadth, quality and efficiency of filing reviews by the SEC staff.

SIA supports an increase in the budget for the Division of Corporate Finance so that, among other things, the SEC has the resources to develop a workable data processing system and the SEC place a greater emphasis on the gathering of corporate information as fast as possible. While not passing on the particular mechanics of the EDGAR system, SIA's Trading Practices Committee's Report stated the Committee's belief that the sooner corporate information can be filed and made public, the less opportunity there is for misuse of such information, especially for illegal insider trading. Further, it is hoped that money spent on computer enhancements for the SEC now will lessen the need for expenditures of money on enforcement in the

While we are not management consultants, large budget increases like large increases in the securities markets must be digested. Excessive increases in staff members in any organization in a short period of time can be counterproductive. In order for new staff members to be trained sufficiently and for existing management to integrate the new staff and their responsibilities into the existing organizational structure, the size of organizations must be increased incrementally over a period of time.

To conclude, SIA feels strongly that the self-regulatory process is worth preserving, and that a strong SEC is indispensable to this result. We support the 27% increase in the SEC's budget for fiscal 1988, in order that the SEC be able to keep up with the increased size and complexity of the securities markets. Also, a steady rise in the globalization of the world's securities markets necessitates that the SEC examine and propose changes in the federal securities laws to accomodate market changes brought about by globalization. Finally, if the SEC succeeds in its efforts to regulate the activities of securities subsidiaries of banks, as it has now proposed legislatively, it may need extra resources.

Thank you Mr. Chairman for the opportunity to appear here today.

Mr. HARRIS. Thank you for your excellent testimony. It's what we wanted in order to make the appropriate judgments on the authorization. I think we need statistical information.

Do you have a research arm? Where do these figures come from?

Mr. O'BRIEN. These figures were developed by our own research department in New York working, of course, with our Washington office as well.

Mr. HARRIS. They are very helpful.

Several witnesses from the securities industry in the past when they testified before the Securities Subcommittee have suggested that this might be an appropriate time to convene an independent group to review the operation of the securities laws in today's markets and recommend appropriate changes.

Do you think the time has come for such a study and, if so, how should it be convened?

SECURITIES LAWS ARE UNDER EXAMINATION

Mr. O'BRIEN. Well, in a certain sense, the securities laws are under examination certainly by our organization right at the moment. As an example, the Trading Practices Committee which was put into effect earlier this year examined some of those Federal securities laws and on the basis of that examination made its proposals.

At the same time, SIA functions through about 36 or so committees, one of which deals with matters of the Federal Regulations Committee, primarily dealing with SEC regulations and Federal laws affecting the SEC and the distribution of information, enforcement and the rest.

So in that sense, much of it is in process and, I might add, has been in process for an additional period of time.

My own judgment is that that would seem to be reasonable, what we are doing, at least for the moment.

Mr. HARRIS. Chairman Riegle, as well as Chairman Shad, both mentioned the importance of the internationalization of the securities markets and you also mentioned globalization in your testimony.

What do you think we ought to be doing in this area that the SEC or the industry currently is not doing? Or how do we look forward in the future toward dealing with the large number of issues involved in this area?

Mr. O'BRIEN. Well, we have a genuine interest in it in the industry, as you can well imagine, the reason being that increasingly business is being done outside of the United States—capital raising being done outside of the United States, starting years ago with the Eurobond business and then expanding into the Euroequity business and so on.

That, in turn, has implications for both enforcement and I might add, for clearance and settlement. For example, I can tell you that clearance and settlement in some countries in Europe sometimes takes months, and in other areas it can be done in a matter of days.

Organizations have been set up throughout the industry, some in the United States, some in Europe, some in the Far East, to deal

with these many questions. In other words, the clearance and settlement questions as well as the enforcement questions.

With the deregulation which became effective in London on October 27, 1986, a whole new era was ushered in and we have set up some people working with us on that subject. That's a little background.

I think that it's important for this committee to become as well informed on these subjects as you possibly can. I think factfinding is indispensable and is really a condition precedent to moving on with whatever regulatory, budgetary, or for that matter, legislative initiatives might be put into effect.

But the globalization is not far off. It's a reality. In fact, I've had to educate myself on this subject a great deal and I must say I've been learning quite a bit in the last few months on the very subject.

Mr. HARRIS. Well, I think this subcommittee on both sides of the aisle look forward to working with you in as apolitical environment as possible in terms of addressing these issues, and your input in terms of anything that we can do to keep the United States the most liquid, the most efficient, and the best capital markets in the world in light of the international competition would certainly be very helpful.

MAJOR ISSUES AND GREATEST CHALLENGES

What do you believe to be the major issues and greatest challenges facing the securities industry within the next, say, 5 years, and what steps do you think the industry itself should be taking to address them and meet these challenges?

Mr. O'BRIEN. I think that the most important challenge for the American securities industry, now the international securities industry, is to keep in mind our dual function, which is to raise capital wherever it happens to be needed—domestically, internationally, for governments, for corporations, for emerging companies, wherever capital is needed.

And I think our second job is to remember that we are basically advising people on their investments. That means we have to be very sensitive to markets, to products and services, and to marketing as a concept, and the whole panoply which deals with the regulatory process as well.

I cannot go on without coming rather quickly to the problem of the insider trading situation. I have been involved with the industry for 34 years and I would tell you that the insider trading situation is a very serious problem and we are taking it so. And I think that the comment made by Chairman Shad is quite accurate—it's a matter of public confidence. That's indispensable for us in order to raise capital and to handle investments. So we've got to be sure that that issue is being addressed.

We have a lot of peripheral issues which by being peripheral are not unimportant. There are human problems, staffing problems, new product problems, marketing. We have a major industry growth here and it's our job to do that growth in the most efficient way we can.

Mr. HARRIS. Mr. O'Brien, let me ask you one final question.

The SIA has been aggressive in terms of taking its own initiative to deal with the problems currently facing the industry. You have set up an SIA Trading Practices Committee. They have made a number of recommendations.

Could you just review so that we have it on the record some of the steps that the Securities Industry Association has been taking with respect to meeting the problems that are currently facing the industry?

Mr. O'BRIEN. The first one, of course, was to put the issue squarely before our board, which we have done on a regular basis. There is not a board meeting that goes on where this subject is not discussed in order to evaluate the implications.

We set up the Trading Practices Committee in order to, again, take some initiative, which, incidentally—I'm glad you mentioned it—we have taken initiative down through the years. In 1976, we did it with linkages of exchanges and some of the surveillance systems that are in effect at the exchanges today are the result of the initiatives taken by the SIA.

Back to the Trading Practices Committee, we have also gone to visit a number of the exchanges after the report was prepared in order to emphasize to them the importance as we see it of a strong self-regulatory mechanism at the exchanges. It ties right in with the importance of getting rid of the small number—and I believe that is the case, but nevertheless, a bad element which has to be eliminated. So we've gone to work with the exchanges on that subject. We have tried to work with Members of the Congress on this subject.

We have a meeting set up on May 22, with all of the exchanges throughout the United States under the auspices of SIA to be held in New York, and our purpose in holding that meeting will be to review with them the current state of affairs, if I can put it that way. We will talk about such matters as the self-regulatory process, how it's going at the exchanges, and I might also add, we have to look to ourselves. It's important, and one of the recommendations made in the Trade Practices Committee report was the establishment of strong compliance activities within the firms themselves and, in fact, increased expenditures of money for that purpose and perhaps a new look at compliance.

In the old days, much of the emphasis was on the retail business in order to uncover unauthorized transactions or things of that nature. We have now got to take another look—and that's in the process—at the investment banking side, and that's one of the recommendations.

So there's a lot in process and it cannot stop.

Mr. HARRIS. Thank you. Mr. Lykos.

INSIDER TRADING QUESTIONS

Mr. LYKOS. One question tangentially related to the insider trading issue. In this committee, various proposals have been discussed that would require the physical separation of the risk arbitrage function from the investment banking function at investment banking firms.

What do you personally think about such a proposal or better, as an industry representative what does the SIA think about this idea?

Mr. O'BRIEN. We gave a little bit of thought to that at the Trading Practices Committee. I was a member of that committee. There were nine of us. And we concluded that it would not be necessary. At least at this stage, we were not prepared to say that there needed to be a separation between the two.

There obviously have to be safeguards established so that the exchange of information within the financial community, particularly within the firm, is under appropriate oversight and appropriate control. But we think that that can probably be done.

Exchange of information is very, very important for investors because it has an effect on pricing, integrity of markets, the simple ability to raise capital, and on and on. And the arbitrage function is not unrelated to that and we don't think that the case has been made to segregate the two at this stage of the game. That's where we stand on it.

Mr. LYKOS. You mentioned in your answer that safeguards have to be established. Are you implying that the safeguards in place now might not be sufficient or that additional safeguards should be looked at by the firms?

Mr. O'BRIEN. No, I am not implying that they are good or bad or indifferent. All I am saying is that a firm should review procedures to be sure that there are appropriate safeguards on this subject.

For example, I know for a fact that it's become rather common in the street ever since the—within the past year, let us say, for firms to with their own staffs, with outside advisers, generally their general counsel or their outside counsel, to review such procedures to be sure that what they had was enough, going in the right direction, whatever the case may be. And that's the right thing to do.

I have been part of those things myself in the course of my lifetime and I don't think it's something that sort of ends and you say, well, we now have it perfect because life changes so quickly in our business.

Mr. LYKOS. Thank you for your testimony, Mr. O'Brien. Senator D'Amato has other questions and will just submit them to you in writing.

Mr. O'BRIEN. We would be glad to answer them.

Mr. HARRIS. We apologize for the lateness of the hour. Thank you very much for coming.

The subcommittee hearing is adjourned.

[Whereupon, at 12:55 p.m., the hearing was adjourned.]

[Response to written questions to witnesses follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
JOHN SHAD

GENERAL RESOURCE LEVEL

QUESTION. Richard M. Phillips, while serving as Chairman of the American Bar Association's Committee on Federal Regulation of Securities, recently said, "I have never been more concerned about the adequacy of the SEC's resources to prevent fraud, promote full disclosure, and otherwise safeguard our securities markets." Mr. Phillips has contended that the SEC's numbers showing an increase in enforcement activity since 1981 actually mask a serious decline in the Commission's capabilities. He asserts that the number of injunctive actions and administrative proceedings have actually declined over the past decade even in the face of enormous growth in the markets. How do you think Congress should respond to this type of ongoing public controversy, involving serious and thoughtful critics, concerning the adequacy of the SEC's resources?

ANSWER. Over the past five years, through automation, paperwork reduction and other staff and Commission initiatives, the increase in the Commission's results have compared favorably with the growth in the marketplace. Since 1981:

° Enforcement actions have increased 63%.

° Full disclosure filings by issuers have increased 35%. SEC reviews of these filings have increased 71%.

° The number of registered broker-dealers has increased 57%. SEC broker-dealer oversight examinations have increased 73% and self-regulatory organization inspections 83%.

° The number of registered investment companies and advisers has increased 86%. SEC inspections have increased 155%.

° The number of shares traded on the New York Stock Exchange has increased 186%, but the number of transactions has increased only 53% because of the growth of large transactions by institutions. The number of investors has increased 46%.

° Complaints to the SEC have increased 55%. Since 1982 all are reviewed. Most involve brokerage back office matters. They are referred to the firms' compliance departments for investigation and written response, and are tracked by the SEC through resolution. Others

are referred to the SEC Enforcement Division, the Justice Department, Self-Regulatory Organizations or state securities commissions for investigation and prosecution if warranted.

The Commission has been able to anticipate and adequately respond to changing conditions in the securities markets, as shown by the agency's productivity record since 1981 as compared with growth in entities and activities regulated by the Commission.

The 30% increase in 1987 ($30.5 million) consists of three parts:

° 15% ($15 million) for the start-up costs of the operational electronic disclosure system (Edgar),

° 8% ($8.4 million) for uncontrollable cost increases

° 7% ($7.1 million) for program staff and ADP procurement.

STATUS OF THE INDIVIDUAL INVESTOR

QUESTION A number of witnesses from the securities industry have recently appeared before the Subcommittee to stress the paramount importance of maintaining the integrity and fairness of the securities markets. They point with concern to the rising apprehension of the individual investor faced with massive securities trading scandals, increasingly complex securities products, and alarming short-term market volatility.

* What is your response to the arguments that the individual investor is not getting a fair shake in today's marketplace, for example, that he/she is being left behind with respect to program trading, protection from insider trading, and enforcement of full disclosure?

ANSWER: Both the SEC and self-regulatory organizations ("SROs") have striven to maintain regulatory programs which ensure the integrity and fairness of the securities markets. Specifically, you raise three areas of concern over the fairness of today's market place for individual investors: program trading, protection from insider trading, and enforcement of full disclosure. The SEC and SRO programs in these areas are discussed below.

Program Trading The SEC, Commodity Futures Trading Commission ("CFTC") and securities and futures SROs have conducted several studies of the impact of index-related stock, option, and futures trading (so-called"program trading") on recent market

volatility1/ These studies have noted the substantial use of index products by professional and institutional investors to shift and control risk and to respond to market movements, but have found no specific abuses (including harm to individual investors) warranting radical regulatory or structural changes at this time. As the markets continue to evolve, however, close monitoring should be maintained. In view of the potential for disruption of the stock market, as well as manipulative or other inappropriate trading in index products and their component stocks, there may be merit to enhanced reporting and recordkeeping procedures for intermarket surveillance of index-related trading.

In addition, the SEC and SROs have developed specific order exposure procedures to minimize market volatility attributed to the quarterly expiration of index options and futures and equity options. These include procedures for early submission to exchange specialists of index-related market-on-close ("MOC") orders to buy or sell certain stocks, and dissemination to the public of buy/sell order imbalances to solicit public orders to

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1/ These studies have analyzed the volatility experienced both on "Expiration" or "Triple Witching" Fridays and in other trading sessions. The most extensive studies have reviewed trading on September 11 and 12, 1986, December 19, 1986, and January 23, 1987. The SEC's Division of Market Regulation recently published a public version of one of these studies, entitled: The Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986.

alleviate such imbalances, thereby mitigating price swings at the market close. These procedures were implemented at the SEC's request by the New York Stock Exchange ("NYSE") for the expirations in September and December 1986 and March 1987, and were operational successes. Similar procedures will be implemented in the June 1987 expiration for both market opening and MOC index-related orders. June 1987 will be the first expiration in which some index products will have their expiration values determined by opening NYSE market prices. The SEC believes that proven NYSE procedures for exposing order imbalances at the opening also should aid in mitigating price volatility from index expirations.

Insider Trading The SEC has sought to protect individual investors from insider trading abuses by enhancing SRO surveillance, investigations and referrals and maintaining an aggressive enforcement program. Each of the major SROs have developed transaction audit trails making possible automated surveillance systems to detect various trading abuses, including insider trading. For example, the New York Stock Exchange ("NYSE") recently began implementing an enhanced automated program to identify suspicious price or volume movements in listed securities based upon deviations from historical, stock-specific trading patterns. In addition, the NYSE has sought to enhance insider trading investigations by developing an automated data base of insiders for listed securities which can be cross

checked with customer account information obtained in investigations. This Automated Search and Match ("ASAM") system is being complemented by the joint efforts of the SEC, SROs and Securities Industry Association ("SIA") to develop automated data submission and analysis capacity for this customer account information compiled in SRO and SEC investigations -- a project commonly referred to as the "Electronic Blue Sheets" program.2/ Finally, the SROs comprising the Intermarket Surveillance Group ("ISG")3/ recently have issued an "Initiative to Enhance Insider Trading Investigations and Referrals" to better coordinate intermarket investigations and expedite SRO referrals of investigations to SEC enforcement staff. This initiative outlines a number of procedures to enable the SROs to refer insider trading investigations within 90 days of detection.4/ These SRO programs should enable the SEC to maintain its highly visible enforcement effort to address known instances of insider trading and deter future abuses harming both the integrity of the securities markets and individual investors.

2/ The questionnaires submitted by investigators to broker-dealers requesting trading information for proprietary and customer accounts traditionally were printed on blue paper, hence the term "blue sheets."

3/ The ISG consists of the ten major stock exchanges and the National Association of Securities Dealers ("NASD").

4/ This 90 day turnaround is a goal for SRO referrals, but obviously certain complex or unusual cases may actually require longer investigative periods.

5

Full Disclosure Both the regulatory and enforcement programs of the SEC have sought to ensure that individual investors and other market participants have timely access to full and fair disclosure of corporate and market information required under the securities laws. In the regulatory area, the Electronic Data Gathering and Retrieval ("EDGAR") project promises not only to enhance the SEC's capability to review the ever-increasing volume of disclosure filings, but should greatly increase public access to the information contained in these filings.5/ This effort is complemented by the SEC's continuing enforcement program to address a wide range of inadequate disclosures of corporate and market information required by the securities laws.

5/ EDGAR may eventually permit individual investors to access corporate data directly through their personal computers.

FUNCTIONAL REGULATION

Question. The SEC has made a concerted effort to regulate certain securities activities of financial institutions and has pressed for Congress to legislate "functional regulation" into place, granting to the Commission securities regulatory authority now held by federal financial regulatory agencies. Yet the Subcommittee has heard repeated testimony questioning the adequacy of the SEC's resources to respond to the expanding regulatory demands of its existing jurisdiction. The Full Disclosure program alone has fallen continually further behind the markets with a declining level of review over the past several years. Particularly in the area of disclosure review, it has been mentioned that the federal regulatory agencies may be better staffed and able to routinely review a much more comprehensive proportion of filed disclosures than the SEC.

What assurances can you provide that the SEC will be able to assume this additional authority and execute it better than under the existing regulatory scheme?

Answer. The additional responsibilities requested by the Commission are consistent with its statutory mandate to protect investors and maintain fair and orderly securities markets. In administering the federal securities laws, the Commission focuses on providing accurate and adequate information to investors so that they may make informed investment decisions. In contrast, bank and thrift agency jurisdiction and regulatory activities are generally concerned with the scope of depository institution activities and the regulation necessary to protect depositors. Thus, as discussed more fully below, transfer of jurisidiction to the Commission would be desirable.

Disclosure review of bank and thrift filings would fit within the Commission's existing operating framework and can be managed effectively and efficiently. The Commission's experience in administering the disclosure statutes assures a compre-

FUNCTIONAL REGULATION

(Question Continued)

hensive and cost-effective approach to regulation. For example, under the integrated disclosure system, the quality of periodic reporting of public companies has been raised substantially. Through the use of selective review, the Full Disclosure Program has concentrated its resources on filings the staff believes most warrant review. Since issuers are assigned to the review branches based on industry (industry centralization), the staff has already developed an expertise in processing filings by financial institutions. With the additional disclosure staff requested to implement functional regulation (34 persons), filings by the additional bank and thrift issuers will be processed in accordance with existing Program guidelines and timeframes for all other publicly-owned companies.

Consolidation within the Commission of the registration requirements under the Securities Act and the disclosure requirements under the Exchange Act for all public companies would also: 1) ensure that investors receive the same disclosure protections with regard to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned entities; 2) facilitate comparative analyses of investment alternatives among individual institutions; and 3) result in more uniform regulation and enforcement of financial disclosure at lower costs.

Under the current regulatory scheme, the bank and thrift regulatory agencies have jurisdiction over disclosure requirements

FUNCTIONAL REGULATION

(Question Continued)

for securities issued to public investors by certain banks and thrifts, and the Commission has jurisdiction over such requirements for securities issued by bank and thrift holding companies. This means that there may be differencies in disclosures relating to banks, depending on whether they are owned by holding companies. These differences may be reflected in the financial statements since the bank regulators specify the accounting principles and other requirements which must be followed in preparing disclosure documents. They also specify whether audits by independent accountants must be conducted.

Uniform accounting standards and disclosure requirements facilitate comparative analyses of investment alternatives among individual institutions, as well as between industry groups such as banks, savings and loan associations, finance companies and securities firms. Such comparative analyses are fundamental to sound investment decisions and efficient securities markets. With the implementation of Edgar, the Commission's electronic disclosure system, public filings will be available on home and office computer screens nationwide, to market and financial analysts, investors, the media and others on a real time basis. With functional regulation, financial and business information for all banks and thrifts, including banks and thrifts now outside of the Commission's jurisdiction, will be available with that of all other publicly-owned companies for analysis using the Edgar system.

FUNCTIONAL REGULATION

(Question Continued)

Finally, enactment of functional regulation would eliminate the inefficiences and anomalies inherent in the current system. For example, there would be no disclosure gaps resulting from delays as the various agencies conform their regulations governing depository institution filings with those adopted by the Commission. In addition, since each of the depository regulators has staff performing the functions handled by the Commission for the 12,000 other publicly-owned reporting companies, duplication in the establishment, interpretation, processing and enforcement of securities disclosure requirements would be reduced or eliminated.

GAO Comments on Budget Process

Q. The GAO has noted that prior to 1980 the SEC provided Congress with details in its budget submission of the Commission's goals and program objectives. In addition, the budget used to describe the extent which the funding requested would accomplish the program goal. Why is this information no longer provided? Does the Commission still set program goals and consider the impact of resource levels in implementing those goals?

A. The Commission's annual budget request is developed in a format approved by the appropriations committees and derivative of an earlier submission each year to the Office of Management and Budget. From 1977 to 1980 the Commission participated in zero-based budgeting as prescribed by the Carter Administration. The Commission was thereby required to establish program goals, long-range objectives, and short-term objectives for the upcoming budget year for each of its programs. In several programs this proved to be a very artificial exercise, forcing the conclusion that the long-range objective of X number of cases would accomplish the program goal of preventing and suppressing securities fraud, for example.

Since 1981 the Commission, along with the other agencies in the executive branch, has returned to a more traditional form of budget presentation. A goal is stated for each program, the operational environment is described, an evaluation is made of the past year, and the projected activities of the current and upcoming budget year are discussed. This format ties activities to realistic and achievable goals consistent with the program's environment. The creation and publication of the agency's congressional justification materials within a

compressed time period in late December and early January is possible each year in large part because these materials are a by-product of the OMB submission made earlier in the fall.

The appropriations subcommittees of the two houses take special interest in the form and content of budget justification materials. Changes in the number and structure of programs or content of these materials may be made only with the concurrence of the subcommittee staffs. The Commission's presentations have been warmly received by the appropriations subcommittees in both houses in the past. The House subcommittee staff recently asked for permission to disseminate the SEC presentation to other agencies in the Commerce, Justice, State appropriation as an example to be emulated.

In 1978, the Securities and Exchange Commission was the first agency to construct a separate justification package to explain its budget authorization request. Prior to 1978 the Commission provided its oversight committees with an annual budget document justifying one figure, while at the same time requesting multi-year authority to spend at different (higher) figures. The authorization document has evolved over the years into the presentation now before the Senate Banking Committee. Its 67 pages include a program-by-program discussion of the possible resource levels necessary in the event of increasing workload and the passage of securities legislation pending before the Congress.

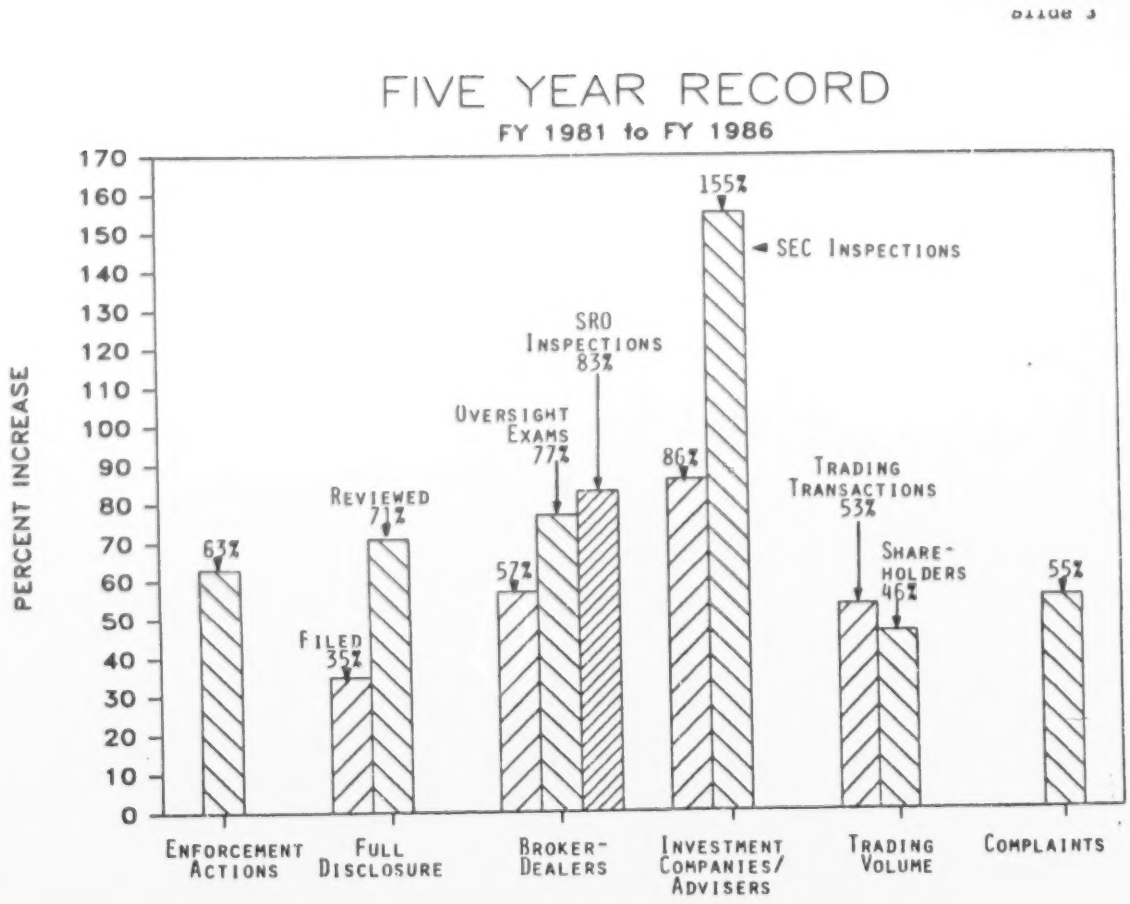
Over the years, the macro approach taken by the authorization document has proven to be well-suited to the determination of the spending ceilings contained in budget authorizations and in fact has been praised by the oversight committees as a useful and informative long-range planning document. As always, the Commission will be pleased to provide additional information to supplement the authorization document upon request by the oversight committees. The detail and format of annual budget materials, however, are not well-suited for this purpose, nor are they developed for the oversight committees with this purpose in mind.

Deregulation

In testimony before the Subcommittee earlier this year, Milton Cohen, a distinguished securities attorney and principal author of the 1963 Special Study of the SEC, pointed out that, "in a highly dynamic field [such as securities] where old concerns are constantly being replaced by new ones or taking new forms, avoidance of new regulatory initiatives is the practical equivalent of deregulation." Has this rationale played any part in the Commission's actions to minimize staff and resource growth during a period of record setting change in the securities industry? Would you regard the Budget as submitted for 1988 as reflecting a deregulatory posture by the SEC?

A. The Commission has and will continue to anticipate and respond effectively to changing market conditions. The record for the past five years demonstrates that through automation, paperwork reduction and other staff and Commission initiatives, the results achieved compare favorably with the growth in the market place. The following table and graph best describe the record results achieved by all divisions.

	Fiscal Years Ended September 30th						1981-86
	1981	1982	1983	1984	1985	1986	Change
Litigation	121	141	161	176	153	179	+48%
Enforcement Actions	191	254	261	299	269	312	+63%
Filings Reviewed	6,153	6,239	6,987	7,237	9,571	10,526	+71%
Broker-Dealer Oversight Examinations	278	249	324	389	447	481	+73%
SRO Inspections	12	19	18	20	21	22	+83%
Invest. Co. and Adviser Inspections	748	1,065	1,085	1,334	1,606	1,906	+155%
Auth. Posns.	2,021	2,021	2,021	2,021	2,046	2,080	+3%
Staff Yrs.	1,982	1,881	1,921	1,885	1,940	1,898	-4%
Budget (000,000) -	$80.2	$83.3	$89.7	$94.0	$106.4	$106.3	+33%
Fees as a Percentage of Budget	81%	94%	110%	129%	135%	203%	


FIVE YEAR RECORD
FY 1981 to FY 1986
PERCENT INCREASE
170
160
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
0
63%
FILED 35%
REVIEWED 71%
57%
OVERSIGHT EXAMS 77%
SRO INSPECTIONS 83%
86%
155%
SEC INSPECTIONS
TRADING TRANSACTIONS 53%
SHARE-HOLDERS 46%
55%
ENFORCEMENT ACTIONS
FULL DISCLOSURE
BROKER-DEALERS
INVESTMENT COMPANIES/ ADVISERS
TRADING VOLUME
COMPLAINTS

The budget request for 1988 will provide the resources necessary to continue the strong law enforcement program and respond to such challenges as internationalization and changes in the banking industry.

The 1988 request of $145,036,000 represents a 27% increase over the 1987 appropriation, as amended. The request includes 2,267 staff positions, a 9% increase over 1987. The funding requested includes approximately:

- $43.8 million for enforcement operations (30%);
- $26.1 million for the full disclosure program (18%);
- $21.7 million for electronic filing (15%);
- $15.4 million for market regulation (11%);
- $13.3 million for investment management regulation (9%); and
- $24.7 million for legal, economic, and support services (17%).

The 181 additional personel requested are for the following efforts:

- 73 for prevention and suppression of fraud (40%);
- 50 for full disclosure (28%);
- 17 for investment management regulation (9%);
- 15 for program direction (8%);
- 12 for market regulation (7%);
- 9 for electronic filing (5%); and
- 5 for legal and economic services (3%).

ECONOMIC AND POLICY ANALYSIS

QUESTION 1. Describe the role of SEC economists in guiding Commission policy during your tenure as Chairman.

ANSWER: SEC economists carry on research in areas of anticipated regulatory concern, providing objective measures of efficiency and the costs and benefits of existing or proposed regulatory schemes. Staff economists also provide the Commission with economic analyses of proposed changes in the regulation of securities markets, and participate in reports to Congress on major issues of importance to the Commission. SEC economists have performed several empirical studies of issues concerning the regulation of tender offers, including the extent of takeover activity, the use of defensive tactics such as poison pills and antitakeover amendments, and market anticipation of tender offers. In addition, SEC economists study various market structure issues. Work in this area includes studies of the multiple listing of options, the internationalization of securities markets, the use of repurchase agreements to finance broker-dealer investments in U.S. government securities, the effects of Rule 415, and the economic effects of program trading.

QUESTION 2. Does the Commission seek balanced economic advice in formulating policy decisions?

ANSWER: Yes, the Commission does seek balanced economic advice in formulating policy decisions. The Commission invites and encourages economists in private industry and academics to present their

views in Roundtables and Hearings on important policy issues such as the regulation of the government securities markets, voting rights of shareholders, and the regulation of tender offers to insure that all viewpoints are heard.

ENFORCEMENT

QUESTION 1. By virtually every measure, the volume, complexity, and number of participants in the securities markets have increased to record levels during these last few years. For example, the number of registered broker-dealers has increased nearly 90% since 1982 and the volume of shares traded on NASDAQ alone increased 145% between 1982 and 1985. The Commission's Budget submission for 1988 notes that the industry growth has also been accompanied by increases in the indices of potential fraud. While the SEC has requested about a 10% staff increase over 1987 in the enforcement program, the staffing of this program for the past several years bears little relationship to corresponding activity in the securities markets. Between fiscal 1981 and fiscal 1985, the enforcement staff actually declined. A former commissioner and a sitting commissioner publicly expressed concern over the staffing levels of enforcement in late 1985 and noted the breaking-point strain of overloaded staffers (Wall Street Journal, 12/16/85). Last February, former SEC General Counsel Harvey Pitt testified before the Subcommittee that, "There can be little doubt that the Commission lacks both the resources and the remedies that are necessary if the agency is to deter securities law violations in the most efficacious manner. Saddled by budgetary constraints and a six-year policy of enforced silence about those constraints, the Commission is in danger of falling behind in the effort to police our securities markets." Can you explain the policy behind decreasing the enforcement staff prior to the recently requested restaffing initiative?

ANSWER. The number of enforcement actions from 1981 to 1986 increased by 63%, from 191 to 312. During the same period the staff remained relatively constant.

The Commission has supported the Administration's efforts to control and reduce Federal spending. However, this support has not been accomplished at the expense of reduced effectiveness in any of the Commission's program areas. Improved productivity has resulted in record achievements for Enforcement and all other divisions.

There has been no Commission policy to decrease the enforcement staff in the years prior to 1987/1988. Although there was a small decrease in authorized enforcement positions from 1981 to 1982, in each year since 1982 the enforcement program was stable or increased slightly.

In 1988, the authorized positions will grow to 754, as compared to 661 in 1986. The following table displays enforcement figures relative to the SEC's entire staffing.

	1981	1982	1983	1984	1985	1986	1987 est.	1988 est.
Total	2,021	2,021	2,021	2,021	2,046	2,080	2,086	2,267
Enforcement	661	638	639	648	654	661	681	754
%	32.7%	31.5%	31.6%	32.1%	32.0%	31.8%	32.6%	33.3%

For 1987 and 1988 a significant staffing increase for the enforcement program, including the addition of a third Associate Director's Office, is needed to keep pace with the vigorous law enforcement effort underway.

ENFORCEMENT

QUESTION 2. Several of the witnesses at our February hearing noted the need for increased automation by the Commission to keep pace with market activity. Former Commissioner Treadway pointed out that the SEC has not even provided modern word processing technology in support of its staff. What automation efforts are underway in the Enforcement program under the proposed 1988 budget?

ANSWER: The Securities and Exchange Commission (SEC/Commission) has recognized and fully appreciates the benefits that can be derived through the careful introduction and integration of state-of-the-art automation. Although funding for equipment has been limited, the Commission has in the past concentrated on the acquisition and use of standalone word processing machines which provided some benefits of automation but lacked the full features of compatibility, communicability, and multi-functionality. For more than three years the Commission has, on a very limited basis, been gradually introducing microcomputers to meet specific critical and data intensive programmatic requirements. The funding for the continuation of this approach with specific emphasis on enforcement operations has been requested as part of the FY 88 agency budget request.

In addition to the need for providing the individual program areas with the direct benefits of automation, the Commission has requested the funding necessary to replace its current obsolete and limited maintainable mainframe central processing units. The replacement of these units is critical in order that the Commission be able not only to maintain its current management

information systems but to also respond to the growing complex and voluminous information reporting and analysis requirements.

The introduction of the microcomputer over three years ago provided the Commission with another powerful tool with which to meet its information handling requirements. With just over 320 microcomputers currently in use Commission-wide, the utility of the microcomputer has been recognized by the various operating elements of the Commission. In general the utilization of the microcomputer has provided for localized computer capabilities for such applications as word processing and spreadsheet operations. While this approach is beneficial to the recipient organizations, it fails to address the substantial benefits to be derived through the introduction of automation to the office management environment. As part of the SEC's overall automation plan to improve both the quality of information and employee effectiveness and efficiency, we are planning to introduce an advanced, comprehensive, state-of-art, integrated office automation system for the staff of the Commission in the future. This planning, however, has been realistically limited due to the current funding limitations and extensive contractual processes.

The goal of the SEC's automation strategy is to fully integrate the diverse and independently developed information technology systems of the Commission. Accessibility to the centralized information systems available through the Commission's main computer system as well as the commercial legal research, regulatory and securities-related firms through a

single, integrated system would yield significant efficiencies. This system would be accessible to all Commission employees through multi-use terminals or microcomputers, as appropriate, located at each employee's work station eliminating the necessity for multiple pieces of hardware and the associated expenses of duplicative acquisition.

Funding requirements have been identified to support the overall development of the automation plans for the period when the Commission will receive the maximum benefit as well as being technically prepared for its implementation. The formal, detailed analysis and studies required by OMB and procurement regulations are currently ongoing. They will provide the necessary documentation as to the accuracy of the Commission's long term information planning and requirements.

In addition to these general automation initiatives, the Commission has several specific enforcement automation projects designed to assist the staff in the receipt and analysis of the complex and voluminous data. These projects are summarized below.

Bridge Market Information Systems

Bridge provides real-time price and volume information, as well as consolidated quotes and news items on exchange-traded and over-the-counter stocks and options. It provides historical trade information which includes data on commodities and financial futures along with on-line graphics. It also permits recall of historical information up to 150 days. Stock/futures

trading is able to be monitored more effectively. The system also permits on-line comparisons between financial futures and their underlying indices and computes an annualized rate of return available through the execution of an arbitrage program. This system has recently replaced the previous vendor at an annual savings of $14,000.

Receipt of Automated Blue Sheets

The Commission's "Blue Sheet" project is a major automation effort currently underway. The Commission and the Securities Industry Association ("SIA") jointly undertook the project, in consultation with representatives of major self-regulatory organizations, broker-dealer firms, and securities industry data processing organizations. The project's name derives from the blue-colored forms currently used by the Commission to collect information from broker-dealers regarding securities transactions.

The goal of the project is to permit the Commission to collect trading information from broker-dealers in electronic format. This will eliminate the need to expend Commission resources on manual computer data entry of information and will facilitate computerized trading analyses. Quality and quantity enhancements are expected, particularly in the pursuit of insider trading, market manipulation, and other cases that require obtaining and analyzing securities trading information.

The project has three phases: development of a uniform format for information to be submitted electronically;

development of means to transmit the information to the Commission; and development of internal Commission software to facilitate data analysis. Principal efforts, to date, have focused on the development of the uniform record layout, which is near completion.

The uniform record layout, while based upon the information currently required by the "blue sheet" form, significantly improves upon the information that will be available to the Commission in its cases, and the utility of that information. For example, information contained in the record layout will permit the Commission automatically to review securities trades by account, by geographic location, by organization, etc. Currently, these types of analyses must often be done by hand, and only with substantial expenditures of staff time. As a by-product of the project, the uniform record layout establishes a useful reference point for further development of computerized information systems by broker-dealer firms.

Self-regulatory organizations have indicated that they will use the same record layout in their requests for securities trading information from member firms. Indeed, the New York Stock Exchange is preparing to mandate use of the record layout by its member firms as a means of providing the exchange with information. Use of one form and means of data collection should prove beneficial to the industry and its oversight organizations.

With respect to the second phase of the project--development of means to transmit information to the Commission--the

Commission has successfully tested the ability to receive computer tapes from individual broker-dealers. We also anticipate, in the near future, formalization of an agreement between the Commission and the Securities Industry Automation Corporation ("SIAC") to use SIAC as a central data collection point for electronic blue sheet information. SIAC, a corporation jointly owned by the New York and American Stock Exchanges, already performs this function for other electronic information, and makes daily transmissions to the Commission. Adding "blue sheet" information to the process should result in minimal expansion of SIAC's current duties, while taking advantage of existing communication links both for industry members and the Commission. This will minimize costs and complications of the process.

The third phase of the project--development of analytical software by the Commission--will be an evolutionary process. The first developments will be general programs that permit viewing the information base in different order and making arithmetic computations, such as total trades in particular accounts. These programs should be sufficient for most analyses. Development of more specialized software will depend in major part on experience, the needs of specific cases, and further technological developments, such as in the area of artificial intelligence.

Enforcement Office Automation Requirements

A project has been recently initiated to review in detail the functional requirements of each of the operating offices within the Enforcement Division. Initial efforts have been focused on the Offices of Market Surveillance and Corporate Practices. It is clearly obvious that the introduction of automation technology, both mainframe and microcomputer, would yield substantial productivity and efficiency benefits for these areas. The automation support derived through the use of the Bridge Systems and the automated receipt of Blue Sheet information have provided the staff with information that would have otherwise not been available. Automation will provide the ability to not only meet the requirements for more sophisticated tracking, but would also provide a method for control over the volumes of documents and testimony acquired in the investigative process. These detailed requirements analysis will form the base for the acquisition of the required automation capabilities should the funding be approved.

New York Regional Office Study

An extensive evaluation of automation resources and functional requirements is currently underway for the SEC's New York regional office, which includes the Office of Enforcement. One of the key findings of the study so far has been the aggressive utilization of available automation resources in the enforcement area making it, as a group, one of the most advanced in "computer literacy". While this office has a limited number

of microcomputers and shared laser printers, it has become necessary to establish a special "microcomputer facility" where two fully-equipped microcomputers are available for shared use by the professional staff who do not have local access to these capabilities. Although this sharing of available automation resources currently maximizes use, there are many more requirements surfacing from this study that will indicate the necessity to introduce advanced integrated office automation capabilities in order to network the existing microcomputers and then ultimately interconnect throughout the entire New York office and to the main SEC headquarters. Initial implementation of the recommendations adopted from this study could commence in FY 88.

ENFORCEMENT

QUESTION 3. Former General Counsel Harvey Pitt highlighted the staff turnover problem at the SEC at the hearing earlier this year. Pointing particularly to attorneys, he noted the difficulty in competing with private sector salaries for securities lawyers which were double or more than the government pay scale. In this regard, U.S. Attorney Giuliani also advised the Commission that the enforcement work of the Commission typically involved very complex cases against the best private attorneys available operating under virtually no budget constraints in conducting their defense. What incentive programs are reflected in the 1988 Budget to reduce staff turnover, eg. cash awards program, training opportunities, workload distribution?

ANSWER. Although the Commission's turnover rate has been higher historically than the Government average, the Commission has viewed high turnover as desirable for several reasons. First, the SEC has attracted the best and brightest to serve a brief tenure and then to enter private practice as well trained, ethical professionals who are familiar with the Commission's requirements. Second, it is well known that many of those talented professionals, with personal and family obligations, cannot be reasonably expected to delay their career financial rewards indefinitely. Third, the continual influx of new staff serves as a wellspring of renewed enthusiasm.

The Commission's 1988 budget includes over half a million dollars for distribution as cash awards to GS and GM employees. Recently the Office of Personnel Management (OPM) gave the Commission delegated authority to hire attorneys and set entrance salaries based upon the employee's prior experience. Since we no longer go through OPM for approval of salaries above step 1, salary negotiations are accomplished more quickly and equitably.

In 1988, the special training program will continue to support litigation training for new trial attorneys. Those programs are

two or three weeks long and typically cost $1,200 to $1,600 per participant not including travel and per diem. Approximately 10% of the Commission's training budget is designated for such trial advocacy training in 1988.

ENFORCEMENT

QUESTION 4: In view of the minimal growth in the 1988 staff and budget for programs other than enforcement and disclosure, what provisions, if any, have been made in the 1988 budget for SEC efforts to promote, and enforce, improved internal auditing and oversight programs in securities firms?

ANSWER: The Commission's 1988 budget provides for an additional four staff years for the Division of Market Regulation and six staff years for the regional office Market Regulation examination program. The Commission believes that these additional resources as well as the substantial resources already allocated to this function will be sufficient to continue the Commission's efforts to ensure proper oversight of broker-dealers and to enhance existing broker-dealer compliance systems.

In addition, in order to fairly evaluate the regulatory oversight program, one also has to look at the increased resources available from the self-regulatory organizations ("SRO's"). During the last four years, the SRO's have increased their examination staff from 302 to 500. In order to ensure that these SRO programs work effectively, the SEC has during the past five years increased by 73% the number of its oversight examinations from 278 to 481.

Furthermore, the Commission has undertaken a direct review of firm's "Chinese Wall" procedures that are intended to protect against improper use of inside

information. The Commission's review revealed that firms need to strengthen and solidify existing Chinese Wall procedures. In that regard, the Commission will oversee the New York Stock Exchange's development of an examination program focusing on the operations of Chinese Walls in multi-service firms, especially in the areas of improving documentation of investment banking transactions, centralization of Chinese Wall controls in the legal or compliance department and the firm's ability to monitor proprietary trading. The Commission intends to work to ensure that standards for Chinese Walls are in place at multi-service firms and are examined and tested regularly by the New York Stock Exchange.

ENFORCEMENT

QUESTION 5. The Budget indicates that the activity levels of other programs, especially enforcement, largely control the General Counsel's litigation workload. The staffing in enforcement is budgeted for about a 10% increase while the staffing in the General Counsel's Office is slated for a 4% increase. Will the resources of the SEC's legal services be sufficient to support the activities resulting from the planned additional enforcement staffing?

ANSWER: The Commission believes that the budgeted resources of the Office of the General Counsel will be sufficient to support the activities resulting from the planned increase in enforcement staff. The Commission recognizes that the enhanced enforcement effort will increase the litigation workload of the Office of the General Counsel because the Office defends suits against the Commission brought by persons seeking to enjoin its investigations, represents the Commission in the U.S. Supreme Court and the Courts of Appeals in appeals involving the Commission's enforcement actions, and prosecutes administrative disciplinary proceedings against professional persons under Rule 2(e) of the Commission's Rules of Practice. It believes, however, that the 4% increase in the staffing in the Office of the General Counsel will be adequate to accommodate this increase.

Not all litigation involving the Office of the General Counsel arises from enforcement matters. The Office also defends challenges to Commission rules and Commission orders not involving enforcement actions and appears amicus curiae on behalf of the Commission in significant private litigation involving the federal securities laws. In addition, under the

supervision and direction of the General Counsel, the Regional Offices represent the Commission in corporate reorganization cases under the Bankruptcy Code that have a substantial public interest. The litigation workload arising in these areas should not be affected by the increase in enforcement staffing.

In addition to its litigation responsibilities, the Office also has a significant legislative and regulatory role. Its workload in these areas will not necessarily be affected by the increase in enforcement staff. Accordingly, the 4% increase in Office of the General Counsel staffing is primarily concentrated in the appellate and district court litigation groups.

Finally, the litigation arising out of enforcement actions in many cases occurs only after the completion of investigations. Similarly, appeals from Commission orders or district court judgments often occur long after the initiation of Commission enforcement proceedings. For these reasons, increases in litigation involving the Office arising from increased enforcement staffing may to a certain extent arise some time after the increase in enforcement investigations. Thus, although the expected budget increase in enforcement will increase the Office's litigation workload, a portion of the workload increase is expected to occur in subsequent fiscal years.

ENFORCEMENT

QUESTION 6. "Out of the nearly 40,000 investor complaints and inquiries anticipated by the SEC for 1988, what criteria are used in determining to open inquiries into only about 800 cases (2%) and how might additional enforcement resources affect this determination?"

ANSWER: There is no direct relationship between the number of investor complaints and the total number of inquiries that the Commission pursues. Investor complaints constitute one of many potential sources of Commission investigations. Other sources include Commission examination and review programs; other Commission investigations; confidential sources and contacts; referrals by other organizations; press reports; voluntary disclosures; and market surveillance activities.

Commission determinations to open inquiries are pragmatic, common sense judgments made on a case-by-case basis. Among the factors that are typically considered are: the age of the possible violation; the degree of harm to the investing public; how many investors were harmed by the conduct; the egregiousness of the conduct; past enforcement history of the subjects of the inquiry; whether the matter or its subjects are related to other enforcement proceedings by the Commission or another organization; geographic location of the conduct and subjects; degree of public interest in the matter; whether the matter is directly related to an area of vital interest to the Commission; the likelihood of success and the adequacy of remedies available after conclusion of the inquiry; whether the matter primarily involves a securities law violation or a violation of other laws; whether action by another organization (federal, state, self-regulatory, or otherwise) would be more

appropriate; and whether the violative conduct was committed by registrants with or practitioners before the Commission.

Additional enforcement resources will not affect the basic nature of the determination to open inquiries. The Commission does not intend to alter its existing enforcement priorities. It will continue to address all areas of fraudulent activity. Additional resources will, however, enable the Commission to enhance cooperative efforts with self-regulatory organizations, state securities commissions, and other law enforcement and regulatory agencies, and may result in the bringing of cases which otherwise might not be prosecuted. Further, while few of the factors listed in the preceding paragraph directly relate to the availability of enforcement resources, that factor is a necessary consideration in the process. Accordingly, the Commission anticipates a general enhancement in enforcement productivity by adding enforcement resources.

FULL DISCLOSURE PROGRAM

Question 1. Chairman Shad has asserted that the SEC is not the sole defense in enforcing full disclosure. He has contended that false or misleading disclosures will be subjected to attack by the private bar in the form of class action suits (Wall Street Journal, 12/16/85). Is the Commission shifting the burden of enforcing full disclosure to individual investors as a means of avoiding the resource commitment necessary for effective prior review and comment by the SEC?

Answer. No. The Commission recognizes the responsibility that the Full Disclosure Program has to protect the integrity and sound operation of the nation's securities markets for the benefit of investors. In this regard, the Commission has requested 50 additional positions for the Full Disclosure Program in 1988 to maintain its review presence during the Edgar transition. The Commission also recognizes that it should fulfill its responsibilities in the most effective and efficient manner possible, so that investors receive the maximum benefit from the Commission's programs at the least cost to taxpayers. It is not cost effective to review all filings. Under the Full Disclosure Program's selective review system, filings are prioritized based on those the staff believes most warrant review. With its commitment to Edgar, the Full Disclosure Program review process will be even further enhanced. Edgar will permit screening of all documents, which is not currently possible. In addition, through the elimination of non-professional and repetitive tasks, more professional manpower will be available for substantive review of filings. The increased facility to access outside data bases and internal industry data will add to the quality, as well as the productivity, of the review process. The result will be a more in-depth review of the financial and business disclosures of a greater number of issuers who file registration statements and reports with the Commission.

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FULL DISCLOSURE PROGRAM

Question 2. The Commission's 1988 budget submission to Congress notes that as a result of the 1986 full disclosure program, the SEC staff issued about 6,000 comment letters, resulting in nearly 3,000 filings being amended. The staff additionally referred 79 matters related to disclosure to the enforcement program. The Commission estimates that its comments on 1933 Act registration statements alone resulted in filing amendments affecting over $106 billion in securities. Under the "selective review" process, these comments were made on what is, in many cases, only a small proportion of the total number of filings submitted. Does a similar volume of incorrect information exist in the enormous number of filings which the staff does not review?

Answer. To maintain an adequate review presence it is not necessary to review each report, merger proxy, registration statement or schedule filed by an issuer. The Full Disclosure Program's system of selective review is sufficient to inhibit fraud and protect investors. Under selective review, the staff reviews those filings which most warrant such scrutiny.

Currently, selective review screening identifies those issuers:

- Making initial public offerings
- With qualified opinions
- With weak financial characteristics
- In material default on obligations
- Subject to investigations
- Delinquent in their filings
- In problem industries
- Who have changed accountants under unusual circumstances
- With anomalous financial ratios
- Offering novel or unique securities; and
- Whose financial statements have not been reviewed recently

The staff's review priorities, which are continually revised to reflect changing market conditions, target those documents most likely to require staff review and comment.

FULL DISCLOSURE PROGRAM

(Question 2., Continued)

Accordingly, the fact that other documents are not reviewed does not suggest that the incidence of incorrect information in these filings is high. Moreover, under the integrated disclosure system, the financial and business information required of an issuer in transactional filings under the Securities Act is the same as that required in periodic reports under the Exchange Act. Thus, unreviewed filings include filings by issuers who have had their financial statements and business disclosures reviewed in connection with other transactional filings or earlier or later dated periodic reports.

FULL DISCLOSURE PROGRAM

Question 3. In testimony before this Subcommittee last February, former SEC General Counsel Harvey Pitt noted that in 1975 the SEC staff reviewed every annual report and annual proxy filed with the Commission. In 1986, the staff reviewed only about 17% of all annual reports and 19% of annual proxies filed. Among all types of filings with the SEC, it has apparently become routine policy to review only some portion of the total and this general proportion is not due to change under the 1988 Budget request. Are you satisfied that the level of review which is now in place provides adequate enforcement of full disclosure?

Answer. Yes. The integrated disclosure system has enhanced the quality of the periodic reporting of public companies, since Exchange Act filings are included in filings under the Securities Act and the financial and business information required of an issuer in transactional filings is the same as that required in periodic reports.

Based on our experience, many filings (when filed) fully comply with disclosure requirements. Since 1981, under selective review, filings have been prioritized based on those the staff believes most warrant review. The priorities are changed with market developments. For instance, with the passage of state law corporate indemnification provisions this past year, the staff undertook to review all Exchange Act proxy statements implementing such provisions. In addition, the staff has developed a procedure for full review of an issuer's financial statements and Management's Discussion and Analysis. With the proposed increase in the number of staff accountants involved in the review process, an increasing number of issuers' audited financial statements will be fully reviewed.

FULL DISCLOSURE PROGRAM

(Question 3., Continued)

Finally, computerization of screening under Edgar will permit more sophisticated screens to be developed, including enhanced industry anomaly screens that could provide for better selection of documents for review or Enforcement investigation. It will also permit immediate screening and prioritization of all documents which are filed. The increased facility to access outside data bases and internal industry data will add substantially to the quality, as well as the productivity, of the review process. The result will be a more in-depth review of the financial and business disclosures of a greater number of issuers who file registration statements and reports with the Commission.

SECURITIES INDUSTRY ASSOCIATION

WASHINGTON OFFICE [illegible] Washington D.C. [illegible] (202) 296-9410

July 24, 1987

The Honorable Alfonse D'Amato
United States Senate
520 Senate Hart Office Building
Washington, D.C. 20510

Dear Senator D'Amato:

In response to your letter of June 1, 1987 to SIA President, Edward I. O'Brien, I have enclosed SIA's answers to your questions in regard to the May 13, 1987 hearing on the reauthorization of the SEC for FY 88.

We appreciate your continued interest in matters affecting the securities industry, and for the opportunity to work with you to formulate mutually agreeable solutions.

If you or your staff have any questions, please do not hesitate to contact me or Jonathan Paret at (202) 296-9410.

Sincerely,

Donald J. Crawford
Senior Vice President and
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Relations

Enclosure
DJC/mn

cc: Thomas Lykos, Esq.
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RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM EDWARD O'BRIEN

Insider Trading

Q. 1(a) In light of the recent prosecutions, do you believe the the civil sanctions imposed by the Insider Trading Sanctions Act need to be increased?

A. We don't believe that we have yet had sufficient time to make a determination that the civil sanctions of the Insider Trading Sanctions Act are insufficient. The law has been in effect for a little less than three years, and, as you know, most of the most recent insider trading scandals, particularly the Dennis Levine and Boesky affairs, were initiated prior to the statute's passage (for instance, Levine opened his account in the Bahamas in May 1980, and Boesky's agreement to compensate Martin Siegel for inside information was entered into in August 1982.) Our suspicion is that the current sanctions are adequate, and that the problem may be that the people behind the recent incidents were confident, mistakenly, that their actions would never come to light. We think it is more desirable to concentrate on vigorous enforcement to dispel such notions from the minds of those who may be tempted to engage in such conduct, than it is a matter of enacting stiffer civil sanctions.

Q. 1(b) Do we really need more severe civil and criminal penalties (5 years and $250,000 fine for each criminal securities law violation) or do we need more cops on the beat to provide a more effective deterrent?

A. We at SIA are not experts on criminal law, and so we are somewhat loath to offer guidance on such questions. However, as we suggested in discussing civil sanctions, we tend to believe that enforcement and detection are the areas to be stressed now rather than penalties. If a greater focus on enforcement means that we need more "cops on the beat", than we are certainly in favor of that.

Q. 1(c) A. We believe this question was directed to the SEC rather than the industry. As you know, we strongly favor an attempt to define insider trading.

Q. 1(d) What specific additional steps would you recommend to crackdown on insider trading?

A. In March of this year, SIA's Board of Directors' Trading Practices Committee issued a report dealing with a number of current issues of concern to the securities industry. One of these issues concerned insider trading. The report contained recommendations for initiatives to be undertaken both by the industry's Self-Regulatory Organizations ("SROs"), and by broker-dealers. Below is an excerpt from the report:

I. **SRO Initiatives** -- SROs should review their supervisory and oversight mechanisms, but great care should be taken not to unnecessarily increase the burden of member firms, either operationally or legally. Firms already do much in the area of compliance, spending millions each year to detect and prevent violations of law. Nevertheless, firms are exposed to much legal liability because of the nature of the business and the litigiousness of society. SROs should focus on specific problems, rather than promulgating broad rules requiring additional paperwork. They should encourage direct, flexible involvement of management in the supervision of business as an alternative to an increase in reports.

II. **Securities Firms Initiatives**

1. Securities firms should be more rigorous in restricting sensitive information on a "need-to-know" basis, and in handling the firm's trading restrictions list.

2. Firms should designate an officer responsible for compliance to be assigned to the Investment Banking Department who will be responsible for developing and enforcing clear written procedures, appropriate to the particular firm, to control access to and assure security of confidential, market sensitive information.

3. Firms should encourage and protect employees who disclose improper activity of which they become aware.

4. Firms should develop training presentations to educate employees of the need for confidentiality of market sensitive information.

5. Firms should require employees annually to execute a confidentiality agreement.

We believe these actions by both the industry's regulators and individual firms would accomplish much to reduce and deter instances of insider trading.

Q. 2. An SEC Office of the Chief Economist Study entitled Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation concludes that the increase in stock prices and trading volume of target shares before a takeover announcement is due to a number of factors that have nothing to do with illegal insider trading. Do you agree with the findings of this report, or do you believe that insider trading is the dominant source of information that spurs a runup in a stock's price before the announcement of a takeover bid?

A. We are aware of the SEC study and certainly agree with its finding that there are a great many factors that may drive up the price of a stock prior to a takeover announcement. For instance, the study indicates that speculation in the news media is responsible for about one-third of the pre-bid trading. All in all, while we are not prepared to quantify the amount of pre-bid trading that can be traced to the abusive use of material non-public information, we are confident that there are many legitimate factors which can create pre-announcement activity.

Q. 3. Do you believe that lowering the Schedule 13D reporting acquisition threshold from 5% to 3% or lower could have any impact on the incidence of insider trading?

A. No, we do not believe that that change would be apt to have any material impact upon insider trading. Moreover, we believe it would potentially decrease the usefulness of the 13D filing, since there would be many additional filings required by the change. For example, at the Senate Banking Committee's June 25th hearing on takeovers, a representative of the Council of Institutional Investors stated that a single pension fund, the California Public Employees Retirement Fund, held between 2 and 4.5% of the stock of 42 companies. Since such holdings are not related to a bidder's attempt to obtain control of a "target" company, filing reports on such holdings would merely create a good deal of additional paperwork without enhancing any of the shareholder protection goals of the Williams Act. SIA strongly opposes lowering the filing threshold.

Q. 4. The first line of defense against insider trading should be the in-house policies and procedures of firms that regularly engage in securities transactions. My perception of these in-house, self-policing mechanisms is that they are illusory and these firms are paying lip service to their commitment to eradicate insider trading. I have introduced legislation that would, under certain circumstances, impose civil penalties upon firms for an employee's violations of the federal securities laws. Do you believe that these firms would have a greater incentive to formulate and implement self-policing mechanisms if the firm was civilly liable for the actions of their employees if they knew or should have known that their employees were trading on inside information? What, if any, provisions of the law permit the SEC to prosecute firms for the actions of their employees? What are the limitations of these laws regarding your ability to prosecute a firm?

A. We respectfully disagree that industry self-policing mechanisms are "illusory." It certainly is the case that they are not foolproof, but that is true about any system of prevention. As unpleasant as it may be to consider, it will always be difficult to catch an employee such as Dennis Levine, who had access to a good deal of confidential information and who betrayed the trust placed in him by his employer and his employer's clients. Recall that Levine established an account overseas in a pseudonym, flew to the Bahamas under an assumed name while paying for his airline ticket with cash, and communicated with his overseas broker via pay telephone booths. Even with the best internal compliance department in the world, such activity will be very difficult to detect, and it is unfair to create a severe standard of liability in such circumstances. This is not to say that nothing can be done to tighten up internal compliance standards; just the opposite was stated in our response to question 1(d) above. But it is to suggest that such a severe liability standard will not entirely prevent abusive use of insider trading, but will mean that innocent parties will be left with virtually no defense.

Q. 5. A Once again, this question seems directed to the SEC. However, we do agree that trading from a foreign location can complicate the task of identifying and preventing instances of insider trading. Care must be

taken, of course, not to initiate activities that might have the effect of curtailing or impeding the international flow of capital. When it comes to the international marketplace, abusive use of material, non-public information is a very small tail on a very large dog.

Takeover Reform -- Amendments to the Williams Act

Q. 1(a) In light of the U.S. Supreme Court's decision in CTS v. Dynamics Corporation upholding an Indiana anti-takeover statute, what specific amendments to the Williams Act would you recommend?

A. As you are aware, this is a difficult and complex area of law. SIA is in the process of formulating a position on amendments to the Act through the input of member firms. Until that process is completed, we are not prepared to make reccomendations.

Q 1(b) A. This appears to be another question directed to the SEC.

Q. 2. Do arbitrageurs play any useful role in the marketplace?

A. Yes. Please permit us to explain our position. Basically there are two sorts of arbitrage. An instance of the older type, sometimes called classic arbitrage, would be a trader who notices a differential in the price of a security or a commodity traded in two markets, and who sells a given amount in one market, thus locking in a profit and helping to drive the price to the same level in both markets.

The other form of arbitrage is usually called risk arbitrage, and it is this form of arbitrage that is involved in corporate takeovers. However, it must be clearly pointed out that hostile takeovers form only one example of the full gamut of transactions where risk arbitrage may come into play. For example, negotiated mergers or takeovers (as distinct from hostile ones), exchange offers, recapitalizations, and spinoffs are also transactions where arbitrageurs may be active. Arbitrage plays a very useful role in permitting the transfer of risk without creating chaos in the marketplace. Another way of saying the same thing is that arbitrage provides liquidity to the market in special situations. For instance, if Company A and Company B announce that they have reached an agreement in principle to merge, it is very likely that the stocks of one or both of the companies will rise to a premium in the market.

However, a shareholder may not wish to hold his shares until the proposed merger is consummated for fear that the merger may be prevented from taking place by any one of a member of factors: for example, the parties may encounter difficulties in reaching a definitive agreement; or perhaps the shareholders will fail to approve the transaction. Or perhaps a regulatory agency, such as the FCC or the FTC, may decide that the merger is not in the best interests of the public, and so fail to approve the transaction in its proposed form. For these or other reasons, shareholders of one or both of the companies may decide they do not wish to hold their shares and risk losing the premium already available in the secondary market. This is where the liquidity and risk transference functions of the arbitrageur come into play. Thus, arbitrage does play a very useful and necessary role in the marketplace.

Q. 3. If a firm has been retained as an investment adviser or banker in a particular takeover contest, should it be prohibited from engaging in any arbitrage activity in the securities of the company involved in the takeover?

A. You are rightly concerned about the possibility of a conflict of interest when a client firm approaches a broker-dealer for investment advice on a merger or corporate takeover. However, it is the standard practice on Wall Street for a firm's arbitrage department to stop its activity (if any) in a security once it is notified that the firm's corporate finance department is engaged in advising the issuer about a proposed transaction; arbitrage departments don't -- and shouldn't -- arbitrage their own firm's deals. This is prohibited through the use of a "restricted list" or similar device.

Q. 4. Do Chinese Walls really work? Should additional incentives such as civil penalities be imposed on firms to ensure that they really work?

A. "Chinese Walls" are not absolutely impregnable, but they can and do work. And as we suggested above, we believe that SROs and firms can take additional steps to see that they work better. We don't believe that additional civil penalties imposed on firms are either useful or fair. The damage that is caused to client relations by episodes of insider trading is a considerable spur to the establishing of secure Chinese Walls even without the prospect of additional civil penalties.

<u>Corporate Democracy -- One-Share/One-Vote</u>

Q. 1. Much SEC analysis and media coverage has been given to the New York Stock

Exchange's (NYSE) application to the SEC which would enable the NYSE to amend its one-share/one-vote listing standards. Do you think that the NYSE listed stocks should be allowed to issue shares with disparate voting rights? Does a movement away from the one-share/one-vote standard mark the death knell for the concept of "corporate democracy?" Should the management of a company that issues stock with disparate voting rights be restricted or precluded from owning stock with full voting privileges in order to avoid management's ability to entrench itself? For the purposes of voting on issues related to changes in corporate control, should the one-share/one-vote principle apply to companies issuing stock that have disparate voting rights?

A. The SIA Board has never adopted a position on one-share/one-vote. SIA is interested in ensuring that shareholder interests are protected, but the one-share/one-vote issue also involves complicated questions about the best capital structure for firms and about the ability of closely held corporations to keep voting control when they decide to go public. We must point out that the various exchanges have had differing standards for voting rights for many years without the issue becoming controversial. It is only during the past few years that the issue has become prominent, primarily as a result of some firms utilizing classes of stock with disparate voting rights as a defense mechanism against a takeover. Thus, we suspect that if the balance between bidders and incumbent management is restored, the issue may largely resolve itself.

Program Trading

Q. 1(a) Is the volatility only limited to 4 triple witching hours each year?

A. Market volatility in relations to program trading is not limited to triple witching hours that occur four times a year when options on indicies, options on individual stock options and futures on indicies of stocks expire simultaneously. Such volatility is induced by the interaction of the commodities and securities markets, specifically the trading of futures based on an index of stocks.

In theory the price of the future should exactly reflect the price of the underlying basket of stocks. In practice supply and demand for the instrument will sometimes result in the future trading at a premium or discount. At

times when the future trades at a discount or premium to the basket of stocks that underlie it, arbitraguers will buy the futures and sell the stocks, or sell the futures and buy the stocks, locking in a profit in the form of the price differential. This arbitrage activity increases the depth and liquidity in the underlying markets and serves to adjust the market prices of the futures and stocks to more accurately reflect supply and demand.

It does, however, result in an increase in activity in the underlying stock markets. This is not a problem except on Triple Witch expiration Friday. During the last fifteen minutes of trading before all three instruments expire, the need of arbitraguers to close out their positions results in so great a volume of orders coming to the floor of the NYSE at one time that the market forces of supply and demand do not have enough time to "smooth out" the market. Prices move dramatically Friday afternoon, and then for the most part recover on Monday morning. Of course, most people only see the dramatic move on Friday afternoon.

Q. 1(b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of program trade driven stock market could lead to a 1929-style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

A. Mr. Phelan's remarks reflected his opinion that it was necessary for stock, options and commodity exchanges, the Securities and Exchange Commission and the Commodity Futures Trading Commission to address the issue of appropriate regulation of program trading. Since the time of Mr. Phelan's remarks that has happened. Consequently, speculation on whether program trading could cause a 1029 crash would be unproductive, the situation that existed at the time of Mr. Phelan's remarks no longer exists. Today the future no longer expires at the same time as the option.

As a result of cooperative efforts by all the affected parties, the Chicago Mercantile Exchange filed a proposal with the Commodities Futures Trading Commission to change the contract of the future it lists based on the Standard and Poor's 500 index. The terms of the change resulted in the settlement price of the future being based on the opening not on the closing price of expiration Friday. The New York Stock Exchange, where the stocks comprising the Standard and Poors 500 trade, adopted a series of rules governing what types of orders could be entered in its market on the opening of expiration Friday for those stocks that comprise the S&P 500. The NYSE also developed increased surveillance systems to monitor trading in the securities in question.

The purpose of the changes at both the Chicago Merc and the NYSE was to reduce volatility in the markets caused by a flood of orders coming to the NYSE during the last fifteen minutes of trading on expiration Friday. With the future priced on the opening, stock traders had all day Friday to enter trades to adjust their positions. The possibility of all the volatility moving from the close to the opening was removed by the NYSE rules that governed what types of orders could be entered in futures related transactions at the opening. The last Triple Witch Friday was uneventful, with no significant impact on market volatility. The matter continues to be monitored by the exchanges and federal regulators.

Q. 1(c) What specific regulation of program trading activity is required?

A. The appropriate regulations of program trading are being developed on an evolutionary basis to avoid disrupting the markets in products that eighty-nine of the ninety days of the quarter serve to reduce market volatility, increase the depth and liquidity of the markets, and benefit the institutions that hold large portfolios of stocks on behalf of individuals. SIA believes the regulators are approaching the problem carefully and would not recommend additional action until the most recent regulatory changes have been in place long enough to have had a serious test.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

March 2, 1987

The Honorable George Bush
President of the Senate
Washington, D.C. 20510

The Honorable Jim Wright
Speaker of the House
Washington, D.C. 20515

Gentlemen:

In fiscal 1986 the Securities and Exchange Commission increased investor protections and reduced unnecessary paperwork and other expenses, ultimately borne by investors. Highlights include:

Record results or the highest levels in years were achieved by all Divisions (see table on page 2). Over the past five years, through automation, paperwork reduction and other staff and Commission initiatives, the increase in the Commission's results has compared favorably with the growth in the marketplace. For example, since fiscal 1981:

- Enforcement actions have been increased 61%.

- Full disclosure filings by issuers have increased 35%. SEC reviews of these filings have increased 71%.

- The number of registered broker-dealers has increased 57%. SEC broker-dealer oversight examinations have increased 73% and Self-Regulatory Organization inspections 83%.

- The number of registered investment companies and advisers has increased 86%. SEC inspections have increased 155%.

- Targeting problem areas has improved the quality of reviews, examinations, inspections and enforcement actions.

- The number of shares traded on the New York Stock Exchange has increased 186%, but the number of transactions has increased only 53% because of the growth of large transactions by institutions and others. The number of investors has increased 46%.

- Complaints to the SEC have increased 55%. Since 1982 all are reviewed. Most involve brokerage back office matters. They are referred to the firms' compliance departments for investigation and written response, and are tracked by the SEC through resolution. Others are referred to the SEC Enforcement Division, the Justice Department, Self-Regulatory Organizations (SROs) or state securities commissions for investigation and prosecution if warranted.

	Fiscal Years Ended September 30th						1981-86
	1981	1982	1983	1984	1985	1986	Change
Litigation‡	121	141	161	176	153	179*	+48%
Enforcement Actions	191	254	261	299	269	312*	+61%
Filings Reviewed	6,153	6,239	6,987	7,237	9,571	10,526*	+71%
Broker-Dealer Oversight Exams	278	249	324	389	447	481*	+73%
SRO Inspections	12	19	18	20	21	22*	+83%
Investment Co. and Adviser Inspections	748	1,065	1,085	1,334	1,606	1,906*	+155%
Authorized Positions	2,021	2,021	2,021	2,021	2,046	2,080*	+3%
Staff Years†	1,982	1,881	1,921	1,885	1,940	1,898	−4%
Budget (000,000)	$80.2	$83.3	$89.7	$94.0	$106.4	$106.3+	+33%
Fees as a Percentage of the SEC's Budget	81%	94%	110%	129%	135%	203%*	

* A record or the highest level in years.

‡ Cases litigated by the Office of the General Counsel, amicus positions, civil subpoena responses and bankruptcy appearances.

† Authorized Positions and actual Staff Years. The differences are due primarily to budgetary constraints and also to government-private sector wage disparities.

\+ After a $4.8 million reduction from the $111.1 million appropriated due to Gramm-Rudman-Hollings, which was restored at the request of the President in fiscal 1987.

Budget: In fiscal 1986 the budget was reduced from the $111.1 million appropriated to $106.3 million ($4.8 million or 4.3%) due to the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act. At the request of the President the Commission's fiscal 1987 budget restored the Gramm-Rudman-Hollings reduction plus $3.4 million. Since 1981, the Commission's budget has been increased 43% to $114.5 million in fiscal 1987. In each of the last four fiscal years registration, transfer and other fees have significantly exceeded the Commission's budget, which has happened only once before in the past 52 years. In fiscal 1986, fees exceeded the budget by 203% or $109 million. The President has requested a $31 million (27%) increase in the Commission's fiscal 1988 budget to $145 million, which is presently pending before Congress. The increase is principally to cover start-up costs of the operational electronic disclosure system ("Edgar") and a 9% increase in authorized positions from 2,086 to 2,267 for enforcement and related activities. The President requests and Congress legislates the Commission's budget, personnel and fees. Fees and fines are remitted to the Treasury as received.

Enforcement: Enforcement actions increased 16% to 312 cases from 269 in 1985. They included 114 broker-dealer and other regulated entity cases, 69 securities offering violation cases, 49 false and misleading financial disclosure cases and a record 34 insider trading cases. In fiscal 1986, court orders required violators to disgorge a record $38 million of illicit profits and to pay $4 million in fines.

On November 14, 1986, a record $100 million consent judgement was obtained against Ivan Boesky. He was also barred from the securities industry, became a

cooperating witness in ongoing investigations by the SEC and the Justice Department and consented to a felony count which may result in up to five years imprisonment and $250,000 in fines.

While insider trading cases have received a great deal of publicity, they have only amounted to 10% or less of enforcement actions in recent years; however, they have increased significantly over prior years. During the past five years, 125 insider trading cases have been brought, as compared with 77 during the preceding 47 years. The large increase is due principally to the increase in corporate takeovers and to improved surveillance and enforcement systems and techniques by the Enforcement Division. With the support of the business and financial community, the investing public, the Administration and Congress, the SEC's ability to expose and prosecute securities frauds has been significantly enhanced by electronic market surveillance systems, transaction audit trails, heavy fines and growing cooperation from abroad (see International Accords below).

The Ivan Boesky and many other cases demonstrate that it has become increasingly difficult for inside traders to hide — at home or abroad — and that those who engage in such activities are assuming significant risks of imprisonment, heavy fines and civil suits, disbarment from the legal profession and the securities industry — and public disgrace. Insider trading has not been eradicated, but it has been inhibited and multimillions of dollars of profits that Boesky and others have been siphoning off the markets are now flowing through to legitimate investors and traders.

International Accords: Starting with the Swiss Accord in 1982, the Commission has implemented additional cooperation agreements on enforcement matters with Canadian, Japanese and United Kingdom authorities. Others are in prospect. The logical extension of these bilateral agreements will be multilateral agreements with virtually all major markets.

At the Commission's initiative in 1986, the 30-nation International Organization of Securities Commissions formed multinational committees to accelerate: cooperation on enforcement matters; the clearance and settlement of international securities transactions; access to each others' markets; and the growth of less developed countries' markets.

The Corporation Finance Division is preparing for the Commission's consideration a proposal to permit so-called "world class" corporations to do investment grade debt, exchange and rights offerings in certain participating countries under prospectuses that comply with their domestic requirements, subject to certain minimum provisions.

International Linkages: Upon the recommendation of the Market Regulation Division, the Commission approved linkage of the Midwest and Toronto stock exchanges, and the first transatlantic exchange of stock quotations by the National Association of Securities Dealers and the London Stock Exchange. The Commission has previously approved linkages of the American and Toronto stock exchanges and the Boston and Montreal stock exchanges.

About 500 companies' shares are now actively trading in more than one country. By the early 1990s we may well witness over a fivefold increase in the number

of companies with shares trading around the clock and the world through a grid of international linkages of major markets and brokerage networks.

Program Trading: By telescoping into minutes and hours transactions previously executed over days and weeks, computerized hedging and arbitrage has increased market volatility in dollars, but not in percentage changes of the averages. Stock index options and futures enable investors, underwriters and others to hedge market risks at a fraction of the prior costs. Computerized arbitrage brings the prices of options and futures into line with those of the underlying securities, which increases the efficiency and liquidity of the markets.

To dampen the volatility on quarterly settlement dates when options and futures expire, the Commission proposed that certain order imbalances be displayed on the ticker tape during the last half hour of trading. The results have been encouraging. The Commission also encouraged and endorsed the Chicago Mercantile Exchange's and the Chicago Board Option Exchange's proposals to settle certain stock index futures and options at opening instead of closing prices, and the CME's proposal to increase its margin requirements. The Market Regulation Division is monitoring these efforts and considering others to dampen interim and settlement volatility.

Tender Offers: To address discriminatory tender offers, the "all holders, best price" rule was adopted. It requires that tender offers be made to all holders of a class of securities and that the best price paid to any be paid to all. The minimum offering period of issuer tender offers was conformed to that of third party offers and withdrawal rights were extended throughout all offers. Legislation was proposed to reduce from ten to two days the 13D disclosure of the acquisition of a 5% interest in a company. The Corporation Finance Division is analyzing extensive responses received to a concept release on "unconventional" tender offers, "poison pills" and companies "opting out" of certain tender offer rules upon shareholder approval.

One-Share One-Vote: Public hearings were held on December 16 and 17, 1986 concerning the New York Stock Exchange's proposal to permit listed companies to issue classes of common stock with different voting rights upon approval by a majority of their independent directors and public shareholders. The Market Regulation Division is analyzing the comments and alternatives.

Electronic Disclosures: The Commission's pilot electronic disclosure system (known as "Edgar" for Electronic Data Gathering, Analysis and Retrieval) successfully completed its second full year of operation. Over 1,000 issuers have filed over 15,000 documents on Edgar. The primary purpose of Edgar is to increase the efficiency and fairness of the markets for the benefit of investors, issuers and the economy by reducing from days and weeks to minutes and hours the public dissemination of time-sensitive corporate information. This will increase the utility of such information to investors, accelerate issuers' access to the market and increase their financing flexibility. Edgar will also assist the Corporation Finance and Investment Management Divisions in improving the efficiency, breadth and quality of their filing reviews and the Enforcement Division in its investigations. Offers for the operational Edgar system have been received and are being evaluated. Comments on an advance rulemaking proposal for electronic disclosures are under review.

Shareholder Communications: To facilitate issuers' communications with their investors, under rules adopted by the Commission, broker-dealers began making available to issuers on January 1, 1986 the identity of their non-objecting shareholders. The Commission has issued similar rules for commercial banks under the Shareholder Communications Act of 1985.

Certificate Immobilization: The Commission is encouraging voluntary immobilization of debt security certificates through the greater use of electronic book-entry systems and central depositories, which will save multimillions of dollars of expenses ultimately borne by investors and reduce paperwork and other problems. Ford Motor Credit Corporation successfully consummated the first public offering of conventional corporate debt on a book-entry basis on October 21, 1986. Also, with the Commission's support, the Government National Mortgage Association announced in December 1986, its intention to begin issuing securities on a book-entry basis through the MBS Clearing Corporation by the third quarter of 1987. Upon the recommendation of the Market Regulation Division, the Commission approved the registration of the MBSCC as a clearing agency through July 1988. GNMA's initiative will accelerate the clearance and settlement of transactions and reduce GNMA fail rates, which have been running in excess of 30%.

Proxies: Proxies were improved and the costs reduced for the benefit of investors through the integration of disclosures, simplification of compensation plan information and greater new registrant disclosures of accountant changes.

Economic Research: The Office of the Chief Economist released economic studies concerning the adverse impact on share prices upon announcement of companies' intentions to adopt "poison pills"; the use of noninvestment grade debt to provide 14% of tender offer financings during the first half of 1985; and the negligible impact on stock prices of SEC enforcement of the ceiling test for those oil and gas companies which use "full cost" accounting. The OCE and the Directorate of Economic and Policy Analysis also published studies finding that multiple listing reduces the cost of transactions in both listed and OTC stock options.

Investment Advisers / Financial Planners: Upon the recommendation of the Investment Management Division, the Commission endorsed the National Association of Securities Dealers' proposed pilot inspection program for the investment advisers of its members and their affiliates, which account for 43% of registered investment advisers.

Litigation: In litigation involving the Office of the General Counsel, the Commission's positions were upheld in 86% of 81 decisions, including the insider trading misappropriation theory in U.S. v. Carpenter (cert. granted); the Commission's authority to administratively discipline accountants in Davy v. SEC; antifraud provision applicability to government securities repurchase transactions in SEC v. Drysdale Securities Corporation; the materiality of ongoing merger negotiations prior to an agreement in principle in Levinson v. Basic; the applicability of Securities Act disclosure requirements to predecessor entities in SEC v. American Board of Trade; and that tax offset rules do not mitigate tax shelter investors' rescissionary damages in Randall v. Loftsgaarden.

Functional Regulation: The Commission testified in support of the Bush Task Group recommendation to consolidate within the SEC the securities reporting re-

quirements of 700 publicly owned banks and thrifts. This would permit more uniform disclosures and enforcement at lower cost. The 12,000 other publicly owned companies, including 1,000 banks and thrift holding companies, presently file with the SEC.

Small Business: In compliance with the Small Business Investment Incentive Act's requirement to reduce state and federal regulatory burdens on small businesses, the Commission adopted and the North American Securities Administrators Association recommended to the states a uniform notification form for certain financings exempt from registration under Regulation D. Also, the asset threshold requiring registration of issuers' securities was raised from $3 to $5 million.

Annual Reports: The Corporation Finance Division approved a General Motors proposal to improve issuers' communications with their shareholders by providing more readable annual reports at lower cost, without reducing the information provided shareholders.

Government Securities: A study prepared in consultation with the Treasury Department and the Federal Reserve Board formed a basis for the Government Securities Act of 1986. The Act requires previously unregulated government securities dealers to register with the Commission. The Commission and the federal bank regulators share inspection and enforcement responsibilities.

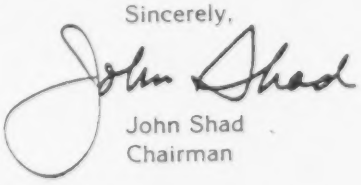
Accounting: Upon the recommendation of the Office of the Chief Accountant, the Commission requested the Financial Accounting Standards Board to address issues related to market value changes in financial instruments, off-balance-sheet financing and risk transfer instruments. Guidance was also provided public companies on reporting the effects of the Tax Reform Act of 1986

Roundtables: Eight open roundtable discussions of the Commission and senior staff were held with leading business, academic and other authorities on major issues concerning the role of investment advisers and financial planners, index arbitrage, takeover developments, disclosure of merger negotiations, surveillance and enforcement programs, independent auditors and other matters.

Legislation: Commission representatives testified at 12 Congressional hearings concerning civil RICO reform, tender offer regulation, SEC appropriations, SEC oversight, bank accounting and financial reporting, disclosure of foreign investments, investment advisers and financial planners, insider trading, financial reporting and the role of the independent auditor, regulation of financial services and other matters. The staff also assisted Congressional committees in drafting legislation and provided studies and other information in response to Congressional requests.

The past year's results are a product of the ability and dedication of the staff and Commissioners. The Commission also received excellent cooperation and support from the business and financial community, the investing public, the Justice Department, the Self-Regulatory Organizations, the state securities commissions, the Administration and Congress.

Sincerely,



John Shad
Chairman

Enforcement Program

Key 1986 Results

The Commission brought 312 enforcement actions during fiscal year 1986, as compared with 269 in 1985. There were 30 cases in which insider trading was the primary violation alleged, and an additional 4 cases where insider trading was alleged in addition to other primary violations. The 34 actions represent the highest number of insider trading cases brought by the Commission in a single year. There was also a substantial increase over the preceding two years in the number of civil and criminal contempt actions. The enforcement program continued to be comprehensive, with actions involving false and misleading financial disclosure, fraudulent securities offerings, and violations by broker-dealers and other regulated entities comprising the majority of the cases.

Total Actions Initiated

	FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	% Change
Total	191	254	261	299	269	312	61%
Civil Injunctive Actions	114	136	151	179	143	162	42.1%
Defendants Named	N.A.	418	416	508	385	477	
Administrative Proceedings	72	106	94	114	122	136	89%
Respondents in Proceedings	N.A.	287	189	221	199	202	
Civil and Criminal Contempt Proceedings	N.A.	9	14	4	3	14	
Defendants	N.A.	16	19	8	6	18	
Reports of Investigation	N.A.	3	2	2	1	0	

In 1986 the Commission obtained court orders requiring defendants to return illicit profits amounting to more than $38.2 million, either as disgorgement or restitution to defrauded investors. Disgorgement orders in insider trading cases amounted to $29.7 million, compared to $2.1 million in 1985. The Commission also recovered $3.7 million during fiscal year 1986 in civil penalties under the Insider Trading Sanctions Act of 1984 (ITSA).

The Commission referred or granted access to its files to the Department of Justice or state prosecutorial authorities in 142 cases, as compared with 145 in 1985. There were 72 criminal indictments or informations obtained during fiscal 1986 in Commission related cases, compared to 59 in 1985. There were 71 criminal convictions in Commission related cases during fiscal year 1986, compared to 93 in 1985.

Full Disclosure System

Key 1986 Results

The full disclosure system is administered by the Division of Corporation Finance. The disclosure system is designed to provide investors with full and accurate material information, foster investor confidence, contribute to the maintenance of fair and orderly markets, facilitate capital formation, and inhibit fraud in the public trading, voting, purchase, and sale of securities.

Full Disclosure Filings Given a Full Review

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	1981-6 Change
Total Filings	6,153	6,239	6,987	7,237	9,571	10,526	+71.1%
Securities Act Registration Statements	2,050	1,857	2,435	2,677	3,385	3,277	+59.8%
10-K Annual Reports	325	1,245*	1,012*	1,283*	2,135*	1,741*	+435.7%
Tender Offers (14D-1)	205	116	92	121	148	146	-28.8%
Proxy Contests	66	68	60	60	86	68	+3%
Annual Meeting Proxies	577	698	895	1,217	1,683	1,629	+192.5%

* Includes reports reviewed in connection with other filings

In fiscal 1986, approximately 12,000 issuers made 76,708 full disclosure filings with the Commission, an increase of 6.7 percent over fiscal 1985. Of these, 1,688 were made by filers through the Edgar system. The number of registration statements filed under the Securities Act of 1933 (Securities Act) increased 29% to 7,356 from 5,696 filings in fiscal 1985. This includes 2,181 and 1,587 filings, respectively, by issuers who had not previously offered securities to the public.

During the year, the staff fully reviewed financial statements of 3,818 different registrants. This included the review of 1,701 registration statements filed by new issuers, 1,340 registration statements filed by issuers with existing public security holders, 236 registration statements relating to mergers or acquisitions involving financial and business disclosures by two or more companies (74 of which were filed by new issuers) and annual reports of 1,741 issuers (17.1 percent of the reports filed). The staff also fully reviewed annual meeting proxy statements of 1,629 issuers, 79 proxy statements relating to going private transactions, 68 proxy contest filings and 504 tender offer schedules.

Regulation of the Securities Markets

Key 1986 Results

The Division of Market Regulation, with the assistance of the Regional Offices, is charged with the responsibility of overseeing the operations of the nation's securities markets and market professionals. In fiscal year 1986, over 11,000 broker-dealers, and ten exchanges as well as the over-the-counter market were subject to the Commission's oversight.

Market Value of Equity Securities Transactions
in billions

FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	81-86 % Increase
$564	$534	$1,005	$1,025	$1,147	$1,735	208%

B/D Oversight Examinations

FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	
278	249	324	389	447	481	73%

Surveillance and Regulatory Compliance Inspections of SRO's

FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	
12	19	18	20	21	22	83%

Matters referred by the SEC Regional Offices to SROs

FY '81	FY '82	FY '83	FY '84	FY '85	FY '86
N.A.	N.A.	132	186	343	235

SRO Final Disciplinary Actions

FY '81	FY '82	FY '83	FY '84	FY '85	FY '86
N.A.	809	802	1,123	971	921

In fiscal 1986 the Commission's secondary market internationalization program made significant progress. The Commission explored issues of concern with securities markets and market participants, facilitated the development of international linkages between securities markets and clear-

ing agencies, and ensured that such linkages incorporate adequate market surveillance and information sharing arrangements.

During the fiscal year, the Commission approved several new options products, a new uniform margin system, and a simplified, more understandable, options disclosure document. The Commission also held a Roundtable on Index Arbitrage trading to develop a better understanding of the benefits gained from stock index products in reducing costs to investors and the price volatility occurring four times during the year when both options and futures expire on the same day.

Progress was made toward a certificate reduced trading environment, by increased reliance on book-entry systems. As a result of efforts this year, forty-six states now allow domiciliary insurance companies to use securities depositories.

In the inspection area, the Commission improved its productivity in the broker-dealer regulatory program through the development of specialized computer programs. These systems also monitor referrals to SROs pertaining to broker-dealer performance.

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Investment Companies and Advisers

Key 1986 Results

The Division of Investment Management oversees the regulation of investment companies and investment advisers under two companion statutes, the Investment Company Act of 1940 (Investment Company Act) and the Investment Advisers Act of 1940 (Investment Advisers Act),and administers the Public Utility Holding Company Act of 1935 (Holding Company Act).

During 1986 the number of registered investment companies increased by 19% and the assets they manage increased by 61%. The number of investment advisers registered increased by 7%. This rate of increase is significantly lower than that experienced in prior years because about 1,500 advisers did not wish to file the new uniform registration form, thus terminating their registrations.

Number of Active Registered Investment Companies and Investment Advisers

	FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	81-86 % Increase
Investment Companies	1,574	1,830	2,057	2,210	2,458	2,912	85%
Investment Advisers	6,265	5,445	7,043	9,083	10,908	11,707*	87%

Investment Company and Adviser Assets Under Management
(in billions)

	FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	81-86 % Increase
Investment Companies	$315	$315	$360	$370	$ 525	$ 742	136%
Investment Advisers	$450	$670	$780	$850	$1,170	$1,400	211%

Inspections/Examinations of Investment Companies and Advisers

	FY '81	FY '82	FY '83	FY '84	FY '85	FY '86	81-86 % Increase
Investment Companies	236	355	348	497	567	643	168%
Investment Advisers	512	710	737	837	1,039	1,263	146%
Total Examinations	748	1,065	1,085	1,334	1,606	1,906	155%

* The registrations of up to 3,000 of these advisers may be cancelled during 1987 for failing to file the new, uniform adviser registration form.

During fiscal 1986 the Division and the regional offices continued efforts to coordinate their regulatory activities with state authorities that share the Commission's jurisdiction over investment advisers, by conducting joint examinations, providing training for state examiners, and routinely sharing examination results.

Due to the large growth in the number of investment advisers registered with the Commission in recent years, the Commission took steps to reevaluate the current regulatory structure for advisers. An SEC Roundtable on Investment Advisers and Financial Planners was held on May 7, 1986 to give the Commission the benefit of the views of outside experts. Discussion at the Roundtable centered on industry growth, and whether it poses additional risks to investors; disclosure to investors and how it can be improved; and alternatives to the current regulatory system, including the establishment of one or more self-regulatory organizations for advisers and greater emphasis on state regulation.

Regulation of investment advisers and financial planners was also the topic of a hearing held on June 11, 1986 by the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce. In testimony at the hearing the Commission stated that, although any abuse is unacceptable, the evidence of abuse by planners and advisers was limited. Improved coordination with the States and productivity enhancements are enabling the SEC to deal with the industry's expansion under current regulation. The SEC is continuing to work with both state regulators and industry representatives to ensure the continuation of cost-effective investor protection.

The staff also cooperated with the National Association of Securities Dealers ("NASD") as it began a pilot program to evaluate the feasibility of conducting inspections of NASD members who are also registered investment advisers. The pilot is designed to provide information on whether the NASD might function as a self-regulatory organization for investment advisers.

The Division and the Regional Offices conducted an investment adviser training program for NASD examiners participating in the NASD pilot program, which will continue into the coming year.

During the year personal computers were used increasingly by Commission examiners, both for on-site inspections of investment companies and investment advisers and in subsequent report writing and file maintenance. These computer applications hold the promise of adding considerable economies to the program's examination capabilities.

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Other Litigation and Legal Activities

Key 1986 Results

	FY '83***			FY '84			FY '85			FY '86		
	Win	Loss	Other*	Win	Loss	Other*	Win	Loss	Other*	Win	Loss	Other*
Supreme Court and Appellate Courts	38	6	3	37	8	5	36	4	5	32	3	2
District Court	40	4	4	26	2	2	23	3	2	21	0	1
Bankruptcy Court**	NA	NA	NA	13	3	2	20	5	0	13	3	1
Other	6	1	6	4	0	0	7	0	0	4	1	0

* Issue not reached, split decision, etc.
** State Courts and Administrative Tribunals
*** Includes third party subpoena cases, which were deleted for FY 1984-1986 results. Figures for FY '81 and FY '82 have not been compiled.

The General Counsel represents the Commission in all litigation in the United States Supreme Court and the Courts of Appeals, defends the Commission and its employees when sued, prosecutes administrative disciplinary proceedings against professional persons under Rule 2(e) of the Commission's Rules of Practice, and appears amicus curiae on behalf of the Commission in significant private litigation involving the Federal securities laws. In addition, under the supervision and direction of the General Counsel, the Regional Offices represent the Commission in corporate reorganization cases under the Bankruptcy Code that have a substantial public investor interest. The General Counsel also seeks to ensure that objectives of the Commission's enforcement and regulatory programs are accomplished, that judicial interpretations of the Federal securities laws afford adequate protection to investors, and that the Commission is able to discharge its statutory responsibilities, unimpeded by lawsuits against the agency or its staff.

The General Counsel represented the Commission in 285 litigation matters during fiscal year 1986. During the year, 37 courts of appeals and Supreme Court cases were concluded, all but three favorably to the Commission. There were 18 appeals before the Supreme Court and Federal courts of appeals of cases in which a party subject to a Commission injunctive action challenged the lower court's resolution of the case in a manner favorable to the Commission or, much less frequently, the Commission challenged an adverse decision. Of these appeals, seven were concluded, with only two outcomes unfavorable to the Commission. The foregoing compares with the following cases in fiscal year 1985: a total of 289 matters, of which 37 were appeals of injunctive action cases. Of those appellate cases, 15 were concluded, with only two outcomes unfavorable to the Commission.

There also were 25 appellate and district court actions seeking to overturn Commission orders, primarily those issued in administrative proceedings or affirming self-regulatory organization disciplinary proceedings against regulated entities such as broker-dealers. Of these appeals, eight were concluded, with no adverse results. In fiscal year 1985, there were 20 actions, 12 of which were concluded with only one adverse result.

The Commission handled 42 amicus cases during the year (compared to 44 such cases in fiscal year 1985). The Commission participated in 19 private cases that were decided; only two of these resulted in a decision adverse to views advocated by the Commission.

The General Counsel also handled more than 218 other proceedings before the Commission or in the Federal district courts, compared to 185 in fiscal year 1985. These included 24 suits brought against the Commission or its staff, and 54 suits, including actions under various public information statutes, seeking access to Commission documents. Of the latter, 46 involved discovery subpoenas in private actions in which the Commission is not a party. In fiscal year 1985, there were 63 suits brought against the Commissioners or the Commission's staff, and 78 suits (including 54 third-party subpoenas) under the various public information statutes.

In addition to litigation, the General Counsel is involved in significant legislative and regulatory work. For example, the Office assisted the Chairman in preparing testimony on a number of important issues, including regulation of financial services, regulation of investment advisers and financial planners, the Commission's responsibilities regarding bank financial reporting, and financial reporting and the role of the independent auditor. The Office also assisted the Commission in preparing a legislative proposal to amend the private civil liability provisions of the Racketeer Influenced and Corrupt Organizations Act.

During fiscal year 1986, 116 debtors with securities registered under the Securities Exchange Act of 1934 (Exchange Act) in the hands of the public commenced Chapter 11 reorganizations. The Commission entered its appearance in 48 of these cases, involving aggregate assets of $10.6 billion and about 260,000 public investors. The Commission entered an appearance in one case to pursue a specific law enforcement interest. A list of these cases is set forth in Table 42 in the Appendix to this Report. The Office also submitted proposed amendments to the Bankruptcy Rules to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States in connection with that committee's review of the Bankruptcy Rules following the passage of The Bankruptcy Amendments and Federal Judgeship Act of 1984.

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